APPENDIX A

Opinion of the Court of Appeals, *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266 (Jan. 30, 1998) (en banc)

Filed January 30, 1998

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 96-5045

KENNETH E. NEWTON; MLPF&S CUST. BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM

v.

MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC.; PAINEWEBBER INC.; DEAN WITTER REYNOLDS
(D.C. No. 94-cv-05343)

JEFFREY PHILLIP KRAVITZ

v.

DEAN WITTER REYNOLDS, INC.
(D.C. No. 95-cv-00213)

MLPF&S CUST. FPO—BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM, JEFFREY PHILLIP KRAVITZ, and GLORIA BINDER,

Appellants

On Appeal From the United States District Court
for the District of New Jersey

Argued October 24, 1996

BEFORE: STAPLETON and NYGAARD, *Circuit Judges*, and MAZZONE,* *District Judge*

Reargued En Banc October 29, 1997

BEFORE: SLOVITER, *Chief Judge*, BECKER, STAPLETON, MANSMANN, GREENBERG, SCIRICA, NYGAARD, ALITO, ROTH and LEWIS, *Circuit Judges*

(Opinion Filed January 30, 1998)

OPINION OF THE COURT

STAPLETON, *Circuit Judge*:

I.

Plaintiff-Appellants are investors who purchased and sold securities on the NASDAQ market, the major electronic market for "over-the-counter" securities, during the two year period from November 4, 1992 to November 4, 1994 ("the class period"). The defendants are NASDAQ market makers. NASDAQ is a self-regulating market owned by the National Association of Securities Dealers ("NASD"), subject to oversight by the Securities and Exchange Commission ("SEC").

An "over-the-counter" market like NASDAQ differs in important respects from the more familiar auction markets, like the New York and American Stock Exchanges. The NYSE and AMEX markets are distinguished by a physical exchange floor where buy and sell orders actually "meet," with prices set by the interaction of those orders under the supervision of a market "specialist." In a dealer

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* Hon. A. David Mazzone, United States District Judge for the District of Massachusetts, sitting by designation.

market like NASDAQ, the market exists electronically, in the form of a communications system which constantly receives and reports the prices at which geographically dispersed market makers are willing to buy and sell different securities. These market makers compete with one another to buy and sell the same securities using the electronic system; NASDAQ is, then, an electronic inter-dealer quotation system.

In a dealer market, market makers create liquidity by being continuously willing to buy and sell the security in which they are making a market. In this way, an individual who wishes to buy or sell a security does not have to wait until someone is found who wishes to take the opposite side in the desired transaction. To account for the effort and risk required to maintain liquidity, market makers are allowed to set the prices at which they are prepared to buy and sell a particular security; the difference between the listed "ask" and "bid" prices is the "spread" that market makers capture as compensation.

The electronic quotation system ties together the numerous market makers for all over-the-counter securities available on NASDAQ. All NASDAQ market makers are required to input their bid and offer prices to the NASD computer, which collects the information and transmits, for each security, the highest bid price and lowest ask price currently available. These prices are called the "National Best Bid and Offer," or NBBO. The NASD computer, publicly available to all NASDAQ market makers, brokers and dealers, displays and continuously updates the NBBO for each offered security.

Plaintiffs allege that technological advances made it feasible during the class period for the defendant market makers to execute orders at prices quoted on private online services like SelectNet and Instinet and that those prices were frequently more favorable to their investor clients than the NBBO price. According to plaintiffs, the defendants regularly used these services and knew that

prices better than NBBO were often available through them. Even though they knew that their investor clients expected them to secure the best reasonably available price, plaintiffs say, the defendants executed plaintiffs' orders at the NBBO price when they knew that price was inferior and when they, at the same time, were trading at the more favorable price for their own accounts. In this way, they were able to inflate their profit margins at the expense of their investor clients. This practice is alleged to violate section 10 of the Securities Act of 1934, 15 U.S.C. § 78j, and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5.

The plaintiffs also charge defendants with two other violations of section 10 and Rule 10b-5. Market makers who simultaneously hold a market order for both sides of a transaction may obtain more favorable prices than the NBBO by "crossing" these in-house orders. Transactions handled in this way are executed within the spread, giving both the purchaser and seller a better price. Similarly, a customer order can be matched by a market maker with an in-house limit order on the other side of the transaction. Since a limit order specifies a particular price at which to execute a transaction, matching another customer order at that price may beat the currently displayed NBBO quote for that security. Plaintiffs allege that the failure of the defendants to execute orders of their clients in these ways when feasible constitutes a fraudulent practice because, by executing at the NBBO rather than matching customer orders, the defendants capture the full market "spread" as a fee for their services without incurring any actual risk in the transaction.

II.

The defendants filed a motion to dismiss for failure to state a claim upon which relief could be granted. At the direction of the district court, this motion was converted into a motion for summary judgment, which was ulti-

mately granted. *See In re Merrill Lynch Securities Litigation*, 911 F. Supp. 754 (D.N.J. 1995). The district court rested its decision on two principal grounds. First, the court determined that the defendants made no misrepresentation. Though recognizing that the defendants, by accepting plaintiffs' orders, impliedly represented that they intended to execute those orders in conformity with the "duty of best execution," the court considered the scope of this duty sufficiently ill-defined that execution at the NBBO could not, as a matter of law, be found inconsistent with the duty. The court concluded that in the face of uncertainty about the scope of defendants' duty of best execution, holding them liable would be "highly imprudent." 911 F. Supp. at 771. Second, the court held that, even if defendants made a material misrepresentation, they could not, as a matter of law, have acted with the requisite scienter.

To state a claim for securities fraud under § 10 of the Securities Act of 1934 and Rule 10b-5, plaintiffs must demonstrate: (1) a misrepresentation or omission of a material fact in connection with the purchase or sale of a security; (2) scienter on the part of the defendant; (3) reliance on the misrepresentation; and (4) damage resulting from the misrepresentation. *See Sowell v. Butcher & Singer, Inc.*, 926 F.2d 289, 296 (3d Cir. 1991). Because plaintiffs have demonstrated that a genuine issue of material fact exists as to the elements of their securities fraud claim, we will reverse the district court.

III.

The parties agree that a broker-dealer owes to the client a duty of best execution. They further agree that a broker-dealer, by accepting an order without price instructions, impliedly represents that the order will be executed in a manner consistent with the duty of best execution and that a broker-dealer who accepts such an order while intending to breach that duty makes a misrepresentation that is material to the purchase or sale. The parties differ, however,

on whether a trier of fact could conclude from this record that the implied representation made by the defendants included a representation that they would not execute at the NBBO price when prices more favorable to the client were available from sources like SelectNet and Instinet.

As we explain hereafter, this difference can be resolved only by determining whether, during the class period or some portion thereof, it was feasible for the defendants to execute trades through SelectNet and Instinet when prices more favorable than the NBBO were being quoted there. This is a matter concerning which the record reflects a material dispute of fact. If such prices were reasonably available and the defendants, at the time of accepting plaintiffs' orders, intended to execute them solely by reference to the NBBO, they made a material misrepresentation in connection with the purchase or sale of the securities involved. If a finder of fact could infer, in addition, that the defendants' implied representation was knowingly false or made with reckless indifference, it would follow that summary judgment for the defendants was inappropriate.

The duty of best execution, which predates the federal securities laws, has its roots in the common law agency obligations of undivided loyalty and reasonable care that an agent owes to his principal.[1] Since it is understood by

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[1] *See, e.g., Hall v. Paine,* 112 N.E. 153, 158 (Mass. 1916) ("broker's obligation to his principal requires him to secure the highest price obtainable"); Restatement of Agency (Second) § 424 (1958) (agent must "use reasonable care to obtain terms which best satisfy the manifested purposes of the principal"). *See also Opper v. Hancock Securities Corp.,* 250 F.Supp. 668, 676 (S.D.N.Y.) ("[T]he duties of a securities broker are, if anything, more stringent than those imposed by general agency law."), *aff'd,* 367 F.2d 157 (2d Cir. 1966). Moreover, as the district court correctly recognized, the best execution duty "does not dissolve when the broker/dealer acts in its capacity as a principal." 911 F.Supp. at 760. *Accord E.F. Hutton & Co.,* Exchange Act Rel. No. 25887, 49 S.E.C. 829, 832 (1988) ("A broker-dealer's determination to execute an order as principal or agent cannot be 'a means by which the broker may elect whether or not the law will impose fiduciary standards upon him in the

all that the client-principal seeks his own economic gain and the purpose of the agency is to help the client-principal achieve that objective, the broker-dealer, absent instructions to the contrary, is expected to use reasonable efforts to maximize the economic benefit to the client in each transaction.

The duty of best execution thus requires that a broker-dealer seek to obtain for its customer orders the most favorable terms reasonably available under the circumstances. *See, e.g., Sinclair v. SEC*, 444 F.2d 399, 400 (2d Cir. 1971) (fiduciary duty requires broker-dealer "to obtain the best available price" for customers' orders); *Arleen W. Hughes*, 27 S.E.C. 629, 636 (1948) ("A corollary of the fiduciary's duty of loyalty to his principal is his duty to obtain . . . the best price discoverable in the exercise of reasonable diligence."), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949). *Accord* Order Execution Obligations, Exchange Act Release No. 37,619A, 61 Fed. Reg. 48290, 48322 (Sept. 12, 1996) ("Final Rules"). That is, the duty of best execution requires the defendants to execute the plaintiffs' trades at the best reasonably available price.[2] While ascertaining what prices are rea-

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actual circumstances of any given relationship or transaction.' ") (citation omitted).

[2] Other terms in addition to price are also relevant to best execution. In determining how to execute a client's order, a broker-dealer must take into account order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. *See, e.g.*, Payment for Order Flow, Exchange Act Release No. 33,026, 58 Fed. Reg. 52934, 52937-38 (Oct. 13, 1993). When the plaintiffs state that better "prices" were reasonably available from sources other than the NBBO, we understand that to mean that, given an evaluation of price as well as all of the other relevant terms, the trade would be better executed through a source of liquidity other than the NBBO (e.g. SelectNet, Instinet, in-house limit orders or market orders held by the defendants, or limit orders placed by the public in the Small Order Execution System). Similarly, for convenience, we use the phrases "best reasonably available price" and "best terms" interchangeably.

sonably available in any particular situation may require a factual inquiry into all of the surrounding circumstances, the existence of a broker-dealer's duty to execute at the best of those prices that are reasonably available is well-established and is not so vague as to be without ascertainable content in the context of a particular trade or trades.

As the SEC has recognized on a number of occasions, the scope of the duty of best execution has evolved over time with changes in technology and transformation of the structure of financial markets.[3] For example, before the creation of NASDAQ, a broker in an over-the-counter market satisfied her duty of best execution by contacting at least three market makers prior to executing a client's order. *See* Order Execution Obligations, Exchange Act Release No. 36,310, 60 Fed. Reg. 52792, 52793 (Oct. 10, 1995) ("Proposed Rules"). With the advent of NASDAQ and the NBBO computer system providing instant access to the best bid and offer available nationwide, the standard for satisfying the duty of best execution necessarily heightened. After the class period, the SEC issued rules that altered the definition of the NBBO to include consideration of many of the alternative sources of liquidity that plaintiffs claim should have been consulted during the class period, such as SelectNet and Instinet. *See* Final Rules, 61 Fed. Reg. at 48306-16. Prospectively, at least, this heightened the standard still further.

Because the scope of the duty of best execution is constantly evolving and because the "reasonably available" component of the duty is fact dependent, broker-dealers have long been required to conform customer order prac-

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[3] *See, e.g.*, Final Rules, 61 Fed. Reg. at 48322-23 ("The scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customers orders, including opportunities to trade at more advantageous prices. As these changes occur, broker-dealers' procedures for seeking to obtain best execution for customer orders also must be modified to consider price opportunities that become 'reasonably available.' ").

tices with changes in technology and markets. For example, the NASD's Rules of Fair Practice, adopted in 1968, required brokers in the over-the-counter market to "use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under the prevailing market conditions." NASD Manual (CCH), art. III § 1, ¶ 2151.03 (1995) (Interpretation A). Included in the factors used to satisfy the requirement of "reasonable diligence" are both "the number of primary markets checked," and the "location and accessibility to the customer's broker-dealer of primary markets and quotations sources." *Id.*

Almost a year before the end of the class period, the SEC staff issued a report entitled "Market 2000: An Examination of Current Equity Market Developments." This report notes that the SEC has consistently taken the position that the evolving nature of the markets requires a broker-dealer to "periodically assess the quality of competing markets to ensure that its order flow is directed to markets providing the most advantageous terms for the customer's order." Market 2000 Report, 1994 SEC LEXIS 136, *11-12. As the term "periodically assess" suggests and as the SEC confirms in its amicus briefing before us, this segment of the report was not speaking to the issue of whether, during the class period, the duty of best execution included a requirement that broker-dealers engage in an order-by-order analysis of competing markets. It does, however, expressly recognize a duty on the part of broker-dealers to periodically examine their practices in light of market and technology changes and to modify those practices if necessary to enable their clients to obtain the best reasonably available prices.

The plaintiffs' orders did not specify the price at which they should be executed. It is a reasonable inference that plaintiffs, in placing their orders, sought their own economic advantage and that they would not have placed

them without an understanding that the defendants would execute them in a manner that would maximize plaintiffs' economic benefit from the trade. Given the objective of the agency and the regulatory background we have reviewed, we conclude that a trier of fact could infer that the defendants' acceptance of the orders was reasonably understood as a representation that they would not be executed at the NBBO price when better prices were reasonably available elsewhere. Accordingly, we must examine the record evidence relevant to whether prices quoted on private on-line services like SelectNet and Instinet were reasonably available during the class period and whether those prices were more favorable than the NBBO when plaintiffs' orders were executed.

The evidence pointed to by plaintiffs indicates that (1) SelectNet and Instinet were in existence throughout the class period; (2) the quotations reported by these services reflected buyers and sellers ready to trade at the quoted prices; (3) the defendants themselves actively traded on SelectNet and Instinet during the class period; and (4) other respected members of the brokerage community, since before the class period, have regarded these services as providing reasonably available prices and have executed orders through them when the prices reported were more favorable to the client than the NBBO price. In addition, the plaintiffs have tendered expert testimony confirming the reasonable availability of execution sources other than the NBBO during the class period.

With respect to whether SelectNet and Instinet prices were more favorable at the time their orders were executed, plaintiffs point to an SEC study of prices during the three month period from April through June 1994. The SEC found that "approximately 85% of the bids and offers displayed by market makers in Instinet and 90% of the bids and offers displayed on SelectNet were at better prices than those posted publicly on NASDAQ." Final Rules, 61 Fed. Reg. at 48308. Plaintiffs have also

tendered evidence of a few trades executed for them by defendants at the NBBO where evidence of contemporaneous offers on Instinet and SelectNet indicate that lower prices were available. Plaintiffs have filed a Rule 56(f) affidavit indicating that they need discovery in order to provide similar evidence with respect to the remainder of their trades.[4]

To be sure, the defendants, with record support, insist that consulting other sources besides the NBBO would have added substantial expense and delay to the execution of plaintiffs' orders, more than offsetting any improvements that might have been available in terms of price.[5] This, however, does nothing more than create a material dispute of fact which we are not permitted to resolve in favor of the defendants at this juncture.

We believe the evidence is sufficient to allow a reasonable trier of fact to conclude that, by the time of the class period, both technology and over-the-counter markets had developed to a point where it was feasible to maximize the

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[4] Defendants suggest that the lack of evidence of injury in all plaintiffs' transactions supports an affirmance on the basis of lack of standing. We believe the evidence we have reviewed in text supports plaintiffs' claim to standing. Plaintiffs submitted evidence that would warrant a finding that several trades were made on their behalf when better prices were contemporaneously available from other sources. The SEC study of 1994 prices suggests that, more likely than not, there were other trades in this category. In any event, the plaintiffs have filed a Rule 56(f) affidavit that would preclude a summary judgment for defendants on this issue at this time.

[5] In particular, the defendants rely upon the existence during the class period of the Small Order Execution System ("SOES"). SOES is an electronic routing system that was created in 1984 to allow orders from small investors to be automatically executed at the NBBO. Defendants claim that since the NBBO was the exclusive source for trades executed through SOES, the duty of best execution was presumptively met for these trades. The evidence to which the defendants point supports their position that execution at the NBBO was a common practice in handling orders from small

economic benefit to the client by taking advantage of better prices than the NBBO. Summary judgment for defendants on this element of plaintiffs' claim was therefore not appropriate.

IV.

As we have noted, recovery on a federal securities fraud claim requires a showing of scienter: a deliberate or reckless misrepresentation of a material fact. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976); *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir. 1985). The alleged misrepresentation here is an implied representation made by the defendants when they agreed to execute the plaintiffs' orders that they intended to maximize the plaintiffs' economic gain in the transaction. Since the defendants knew of the plaintiffs' profit motivation, they must have understood, according to the plaintiffs, that plaintiffs would expect them to obtain a price more advantageous to the plaintiffs than the NBBO when one was readily available. If the defendants intended not to act in a manner consistent with this expectation when they accepted the orders and yet did not so advise plaintiffs, plaintiffs insist that the defendants can be found to have made an implied representation that they knew to be false.

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investors. It does not alone, however, require a finding that trades at better prices through SelectNet or Instinet were not reasonably available even for small orders or that a broker-dealer's duty of best execution was automatically discharged by executions through SOES. While size is undoubtedly a relevant factor in determining the scope of the duty of best execution, for summary judgment purposes we find the state of the record with respect to small orders no different than the record with respect to other orders. The affidavit of Richard Y. Roberts, who served as the chairman of the SEC throughout the class period, notes that, to his knowledge, the SEC did not take the position that execution through SOES automatically satisfied the duty of best execution, and indicates that, in his opinion, such a position would be contrary to several SEC releases. At any rate, not all of plaintiffs' orders were executed through SOES.

We believe that a reasonable trier of fact could find this chain of inferences persuasive based on a straight forward economic analysis of the plaintiffs' relationship with the defendants. In addition, however, plaintiffs rely upon evidence showing that respected members of the brokerage community recognized, even prior to the class period, that trades were readily available from sources other than the NBBO and that their clients expected them to take advantage of those sources whenever it would benefit the client. *See, e.g.*, Declaration of Paul M. Lacy [A 718]; Declaration of Junius W. Peake [A 755]; Declaration of Richard Y. Roberts [A 775]. Moreover, the plaintiffs have shown that an SEC study found clear evidence of a two-tiered market during the class period, in which NASDAQ market makers routinely traded at one price with retail clients like the plaintiffs and at a better price for themselves through quotation services like SelectNet and Instinet. *See* Final Rules, 61 Fed. Reg. at 48307-08. They have further shown that the possibility that the duty of best execution might require resort to sources other than the NBBO was being actively debated during the class period and that that debate ultimately resulted, shortly after the class period, in a regulation effectively requiring as much. *Id.*

All of this would allow a reasonable trier of fact to find that the defendants' misrepresentation—namely, that they would execute plaintiffs' trades in a manner maximizing plaintiffs' economic gain—was at least reckless, if not intentional. *See Healey v. Catalyst Recovery of Penn., Inc.*, 616 F.2d 641, 649 (3d Cir. 1980) (defining recklessness as an extreme departure from ordinary care).

Defendants have countered with affidavits of other respected members of the brokerage community stating that their practice during the class period was the same as that of the defendants. This evidence could, of course, be regarded by a trier of fact as probative of the defendants' state of mind when they accepted plaintiffs' orders. But

these affidavits do no more than raise a material issue of fact as to whether the defendants knew of the expectation plaintiffs claim to have had; they do not settle the matter.

At trial, the defendants would certainly be entitled to argue to the jury that, because of industry practice, they thought their clients would expect them to execute only at the NBBO or that they never thought about their clients' expectations. Moreover, any evidence, derived from knowledge of industry practice or elsewhere, that the plaintiffs were generally aware of the defendants' exclusive reliance on the NBBO would, of course, be quite probative of whether the plaintiffs had the expectations they claim. But the defendants, in elevating the practice of a segment of the industry to be outcome determinative, lose sight of the fact that the basis for the duty of best execution is the mutual understanding that the client is engaging in the trade—and retaining the services of the broker as his agent—solely for the purpose of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal. Based on this mutual understanding and the absence of any express limitations on the brokers' responsibility, a trier of fact could find that the defendants, although intending to execute with sole reference to the NBBO, understood that they were expected to utilize sources other than the NBBO when a better price was readily available.[6]

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[6] The foregoing analysis is generally applicable to plaintiffs' claim that it was reasonably feasible for defendants to "cross" customer orders on opposing sides of a transaction and match customer orders with in-house limit orders. Plaintiffs' record support, including affidavits from respected members of the investment community, raises a disputed issue of material fact as to whether these practices were reasonably feasible during the class period. If the defendants intended to execute plaintiffs' orders at the NBBO despite the reasonable availability of these alternative pricing sources, and if the defendants acted knowingly or with reckless indifference to the falsity of their material representations, then plaintiffs have a securities fraud claim for these practices as well.

V.

In concluding as we do, we are not unmindful of the fact, deemed determinative by the district court, that execution of customer orders at the NBBO was a practice "widely, if not almost universally followed" in the securities industry during the class period. 911 F. Supp. at 772. Under the district court's logic, a Section 10(b) defendant would be entitled to summary judgment even if it were her regular practice to knowingly violate the duty of best execution, so long as she could identify a sufficient number of other broker-dealers engaged in the same wrongful conduct to be able to argue in good faith that the underlying duty was "ambiguous." We cannot accept an analysis that would produce such a result.

Even a universal industry practice may still be fraudulent. *See Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1171-72 (2d Cir. 1970) (non-disclosure of widespread industry practice may still be non-disclosure of material fact); *Opper v. Hancock Securities Corp.*, 250 F. Supp. 668, 676 (S.D.N.Y.) (industry custom may be found fraudulent, especially on first occasion it is litigated) *aff'd*, 367 F.2d 157 (2d Cir. 1966); *see also Vermilye & Co. v. Adams Express Co.*, 88 U.S. 138, 146 (1874). Indeed, the SEC recently completed an investigation in which it found that certain practices by NASDAQ market makers, not at issue here, were fraudulent even though they were widely followed within the industry. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market, 1996 SEC LEXIS 2146 (Aug. 8, 1996).

As defendants emphasize, the practice of exclusive reliance on the NBBO has never been held to be fraudulent by any court or regulator. On the other hand, there is no statute, rule, regulation, or interpretation, by the SEC or by a court, that authoritatively establishes that, for all trades, the NBBO exhausted the category of "reasonably available prices" during the class period. This absence of

precedent did not, however, absolve the district court of the duty to resolve the plaintiffs' securities fraud claim once it was presented in this suit.

"In the final analysis, ultimate responsibility for construction and enforcement of the securities laws must rest with the court." *Langert v. Q-1 Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 94,445, at 95,540, 1974 WL 377 (S.D.N.Y. Mar. 15, 1974). The district court was not deprived of this enforcement authority just because no court or regulator had previously chosen to exercise such authority with respect to the practice challenged here. *See, e.g., Chasins*, 438 F.2d at 1171-72 (finding that defendant's failure to disclose its market maker status was material omission under Section 10(b), despite fact that SEC had never previously held that such disclosure was required).

VI.

On the record before us, we believe a reasonable trier of fact could conclude that the defendants misrepresented that they would execute the plaintiffs' orders so as to maximize the plaintiffs' economic benefit, and that this misrepresentation was intentional or reckless because, at the time it was made, the defendants knew that they intended to execute the plaintiffs' orders at the NBBO price even if better prices were reasonably available. A reasonable trier of fact could thus find scienter with respect to a material misrepresentation, as well as the other elements essential to a Section 10(b) fraud claim. Accordingly, we will reverse the summary judgment entered by the district court and remand for further proceedings.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX B

Opinion of the Court of Appeals, *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 96-5045 (June 19, 1997)

Filed June 19, 1997

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(D.C. No. 94-cv-05343)

JEFFREY PHILLIP KRAVITZ

v.

DEAN WITTER REYNOLDS, INC.
(D.C. No. 95-cv-00213)

MLPF&S CUST. FPO—BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM, JEFFREY PHILLIP KRAVITZ, and GLORIA BINDER,

Appellants

On Appeal from the United States District Court
for the District of New Jersey

Argued October 24, 1996

Before: STAPLETON and NYGAARD, *Circuit Judges*, and MAZZONE,* *Senior District Judge*

(Opinion filed June 19, 1997)

OPINION OF THE COURT

NYGAARD, *Circuit Judge*.

The issue on appeal is whether the over-the-counter customer order execution practices of several large stock brokers constituted securities fraud. The district court concluded that these practices were not fraudulent and granted summary judgment in favor of the defendants. We will affirm.

I.

The facts of this case are set forth thoroughly in the district court's opinion. *In re Merrill Lynch Securities Litig.*, 911 F. Supp. 754 (D.N.J. 1995). Succinctly stated, plaintiffs are investors who purchase and sell so-called "over the counter" securities which are traded on a computerized price quotation system known as NASDAQ. They claim that the peculiarities of this market have given securities dealers an opportunity—upon which they have capitalized—to inflate their profit margins at the expense of customers, resulting in inferior execution prices vis-a-vis other dealers who have access to superior, privately quoted prices. These practices, plaintiffs allege, violated the defendants' duty of best execution, but were never disclosed by the dealers, thus amounting to a securities fraud under section 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(a) and Rule 10-b5 promulgated thereunder, 17 C.F.R. § 240.10b-5.

* Honorable A. David Mazzone. United States District Court for the District of Massachusetts, sitting by designation.

The NASDAQ, which is now the second-largest securities market in the United States, is different from the New York and American Stock Exchanges, because it is a dealer-created, rather than an auction, market. In an auction market, buy and sell orders actually "meet" on the exchange floor, with prices being set by the continuous interaction of those orders, under the supervision of market "specialists." This type of market has traditionally been used for widely traded securities.

Dealer markets, on the other hand, rely on "market makers" to set prices and maintain the liquidity of securities. This system arose out of literal, over-the-counter trading of stocks that were not as widely traded as those listed on the NYSE or AMEX. In a dealer market, each market maker decides the prices at which it will buy and sell a security; the difference between the listed "ask" and "bid" prices is known as the "spread," from which the market maker is compensated for its efforts and risk.

Under that system, of course, as long as timely, accurate information is available regarding each market maker's prices, orders will naturally gravitate towards the dealer with the most favorable prices, and this will establish a single, albeit two-price, market for each security traded. NASDAQ (which stands for National Association of Securities Dealers Automated Quotation) is the information system that relays market makers' pricing information to buyers and sellers. NASDAQ quotes the National Best Bid and Offer—known in the industry as the "NBBO"—price for every stock on the system.

Because of recently created sources of additional, non-public pricing information, however, the NBBO may no longer always be counted upon to display the "best" price. Systems such as SelectNet and Instinet, which are not available to all investors or even to all dealers, may be quoting a more favorable price than the NBBO at any given moment. Appellants allege that, not only were bet-

ter prices displayed in many instances, but that the defendant dealers knew such prices were available, yet continued to book their orders at the inferior, NBBO price at the same time that they were trading at the more favorable price for their own accounts.

In addition, in many instances dealers are able to obtain more favorable prices by "crossing" the customer's order with the order of another customer. For example, assume that a dealer quotes an "ask" price of $32¼ and an "bid" price of $32 for shares of XYZ Corporation. A customer places an order to purchase 100 shares, but, unbeknownst to him, the dealer has an outstanding limit order from another customer to sell at 32⅛. That dealer could simply cross the two orders and execute the trade at 32⅛, saving the customer $12.50. The dealer would not incur any market risk on such a transaction. Appellants allege that it is a fraud for the defendant dealers to continue to execute trades at the NBBO price, appropriating the full "spread" as a fee for their services.

The district court granted summary judgment to defendants, for two principal reasons. First, it held that defendants made no actionable misrepresentations, because the duty of best execution is ill-defined and there is no widely accepted view that execution of trades at the NBBO price fails to satisfy that duty; thus, it would be improper to find that defendants omitted or concealed material facts. 911 F. Supp. at 771. Second, the court held that, even if defendants omitted information, they could not, as a matter of law, have acted with the requisite scienter. *Id.* at 772.

II.

A.

To make out a securities fraud claim under § 10 of the Securities Act of 1934 and Rule 10b-5, plaintiffs must

show: (1) a misrepresentation or omission of a material fact in connection with the purchase or sale of a security; (2) scienter on the part of the defendant; (3) reliance on the misrepresentation; and (4) damage resulting from the misrepresentation. *Sowell v. Butcher & Singer, Inc.*, 926 F.2d 289, 296 (3d Cir. 1991). Although the district court held that there was no misrepresentation or omission of a material fact, we will assume, without deciding, that the trading practices here constituted an otherwise actionable misrepresentation, because we conclude that the district court correctly decided that scienter was lacking as a matter of law, and appellants' securities law claims fail on that basis alone.

The element of scienter has been defined as "a mental state embracing intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12, 96 S. Ct. 1375, 1381 n.12 (1976). Scienter can also be established by a showing of recklessness, which is defined as "an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading . . . that is either known to the defendant or is so obvious that the actor must have been aware of it." *Healey v. Catalyst Recovery, Inc.*, 616 F.2d 641, 649 (3d Cir. 1980) (quoting *Sundstrand v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)). The recklessness standard comprehends actions very close to intentional conduct; mere indifference to the consequences of a statement is not sufficient. *Healey*, 616 F.2d at 649.

Appellants assert, nevertheless, that the record before the district court contained sufficient evidence from which a rational factfinder could infer scienter. The district court disagreed, opining that because the duty of best execution is not "established," but ambiguous, the failure to disclose that all orders were being executed at the NBBO price could not, as a matter of law, have involved scienter. We agree.

Appellants attempt to refute the district court's reasoning by arguing that "the absence of a regulation prohibiting a specific practice does not mean such practice cannot be considered fraudulent." Specifically, they rely on our decision in *Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 835 F.2d 1031 (3d Cir. 1987), which they assert is "directly on point." We are not persuaded.

It is true that *Ettinger* involved a securities firm that failed to disclose excessive markups, but there the similarity to this case ends. The dealer in *Ettinger* argued that its compliance with Rule 10b-10 insulated it from a material misrepresentation attack under Rule 10b-5, and we held simply that such compliance did not preclude a 10b-5 action. *Id.* at 1036. Moreover, *Ettinger* involved a markup practice that both the SEC and the courts had already condemned—the duty in that instance, unlike here, was clear. *See id.* at 1033. And finally, scienter was not even an issue in *Ettinger*. It had been waived in the district court. *Id.* at 1036 n.7. *Ettinger* is inapposite.

Appellants also cite several cases which allegedly stand for the proposition that violations of § 10(b) can occur when a broker-dealer fails to execute customer orders at the best possible price. Two of those cases, however, involved execution practices that no reasonable dealer could have possibly believed proper. *See Barnett v. United States*, 319 F.2d 340, 345 (8th Cir. 1963) (excessive mark-ups of between 25 and 67% not disclosed; customer order never executed at advertised price, while dealer was trading same security for its own account at superior price); *Opper v. Hancock Securities Corp.*, 250 F. Supp. 668, 673 (S.D.N.Y.), *aff'd*, 367 F.2d 157 (2d Cir. 1966) (dealer claimed to be searching unsuccessfully for buyer to purchase customer's stock, while at the same time trading in that same stock profitably for its own account). Three other cases interpose a third-party dealer in the transaction, thus increasing the customer's expense; this

practice had already been condemned by long-standing judicial and regulatory authority. *See Sinclair v. SEC*, 444 F.2d 399, 400 (2d Cir. 1971); *In re Delaware Management Co.*, 43 SEC 392, 399-400 (1967); *In re Hoit Rose & Co.*, 1969 SEC LEXIS 244 (1969).[1]

As the district court recognized, the most instructive case on the issue of scienter is *Platsis v. E.F. Hutton & Co.*, 946 F.2d 38 (6th Cir. 1991). There, a broker failed to disclose its production credits, spreads or markups, while at the same time it was profiting from customer transactions against its own inventory. The district court found, after trial, that defendants had acted with scienter, but the court of appeals reversed because there was no established regulatory duty to disclose and intent to deceive could not thus be established by omission. Here, as in *Platsis*, the dealers were under no established duty to execute trades at other than the NBBO price or to disclose their execution practices. Indeed, it appears that the industry as a whole used the NBBO to satisfy the duty of best execution. Under the reasoning of *Platsis*, then, which we adopt, there was no scienter. *Accord Shivangi v. Dean Witter Reynolds, Inc.*, 825 F.2d 885, 889 (5th Cir. 1987) (failure to disclose sales compensation did not involve scienter when no court or regulator had ever held that information material and there was no evidence that its disclosure was normal industry practice).[2]

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[1] Indeed, the only authority appellants are able to cite with facts similar to the present case is an unpublished district court opinion in typescript. *Lesko v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. C78-1740 (N.D. Ohio June 22, 1979), in which the court opined, with very little analysis, that a deliberate policy of sending all orders to the AMEX rather than "seeking the best price in the available markets" stated a claim for securities fraud. That court did not discuss scienter, and is thus inapposite, whatever its relative persuasiveness.

[2] The district court and appellees maintain that this circuit already follows a *Platsis*-like rule. In *Christidis v. First Pennsylvania*

On the other hand, in *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970), a broker failed to disclose that it was making a market in certain securities it strongly recommended, and then sold, to plaintiff. Although scienter was not directly at issue in *Chasins*, the court did opine that all brokerage firms had followed the same practice and had never thought such disclosure was required. Moreover, the SEC had never prosecuted any firm for this violation. Indeed, as here, the practice at issue in *Chasins* was later addressed by regulation. *Id.* at 1171 n.5.

Nevertheless, we decline to apply *Chasins* to this fact pattern. First, the holding there did not address scienter. *See Architectural League v. Bartos*, 404 F. Supp. 304, 315 (S.D.N.Y. 1975) ("All that . . . *Chasins* holds . . . is that failure to disclose market-maker status was . . . the omission of a material fact. The omission of a material fact, without more, does not violate Rule 10b-5. All other elements, including scienter, must be proven[.]"). Second, in *Chasins*, appellant's contention that *nobody* thought disclosure was required was demonstrably false, having been impeached by appellant's own witness. 438 F.2d at 1171. That is not the case here. Finally, and most importantly, in *Chasins* the dealer was strongly recommending that the customer buy certain securities in which the dealer itself was making the market. The dealer thus had

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Mortgage Trust, 717 F.2d 96 (3d Cir. 1983), plaintiffs sued an accounting firm, alleging that it fraudulently failed to prepare financial statements in accordance with generally accepted accounting principles. Although scienter as such was not an issue, we affirmed the dismissal of the complaint for lack of particularity in pleading fraud under Fed. R. Civ. P. 9(b). *Id.* at 100. We do not read *Christidis* as itself adopting the proposition that failure to disclose cannot involve scienter where there is no clear duty to do so and the practice at issue is common in the industry. It was simply a case involving the pleading standard for allegations of fraud. Nevertheless, we think that *Platsis* is persuasively reasoned and we adopt it here.

an undisclosed conflict of interest of major proportions; to the extent that the customer followed its "advice," the dealer made more money. *See Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 482 F.2d 880, 885 (5th Cir. 1973) (distinguishing *Chasins* on this basis); *Batchelor v. Legg & Co.*, 52 F.R.D. 553, 557 (D. Md. 1971) (similar).

We therefore hold that, where defendants are under no affirmative legal duty to disclose their order execution practices and those practices are widely followed within the securities industry, as a matter of law there is no scienter when defendants fail to disclose those practices.

B.

In this case, although it appears on the surface that appellants have adduced evidence that the nondisclosures at issue here were not common industry practice, closer examination reveals that contention to be unsupported. Appellants first cite the deposition testimony of Paul M. Lacy, a retired securities trader, for the proposition that "other broker-dealers do not execute customer orders with exclusive reference to NBBO." His testimony supports nothing. Mr. Lacy retired *before* the beginning of the class period (November 1992), and therefore cannot offer any competent, firsthand testimony about industry practices as they existed at the times material to this litigation. Of even greater significance, Lacy did not even testify about the practices of other securities dealers in general or even his former firm in particular, but testified only about *his own* practices as a trader within that firm.

Appellants also rely on proposed SEC rules on order execution as confirmation of Lacy's testimony [A 609]. *See* Order Execution Obligations, 60 Fed. Reg. 52,792 (1995) (to be codified at 17 C.F.R. pt. 240) (proposed Oct. 10, 1995). That document recites that traders use "a variety of systems and procedures" to satisfy best exe-

cution. *Id.* at 52,794. If traders use a *variety* of systems, however, that bolsters the district court's conclusion that there was no clear duty to supplement the NBBO price and that failure to disclose the practice of executing all trades at the NBBO price could not have involved scienter.

Appellants likewise refer us to the opinions of a trader and a former SEC commissioner who believe that the duty of best execution requires affirmative efforts to supplement the NBBO with other sources of pricing. *See National Market System: Hearings Before the Subcomm. on Telecommunications & Finance of the Comm. on Energy & Commerce,* 103d Cong., Serial No. 103-67, at 355 (1993) (statement of securities dealer Bernard L. Madoff that he believes it is the obligation of a market maker to achieve price improvement whenever possible and does so in fifty percent of all trades); Declaration of former SEC Commissioner Richard Y. Roberts, [A777] ("[i]t would be inconsistent with the duty of best execution for a broker-dealer to advantage itself by automatically executing customer orders at the NBBO when superior prices are reasonably available"). This evidence, however, is insufficient.

To prevail on summary judgment, one need not show that *every* dealer executes trades at the NBBO price, but merely that enough dealers do so that the duty to supplement the NBBO price is *ambiguous* and scienter is negated. There is more than ample evidence of that. David S. Ruder, a former Chairman of the SEC, member of the NASD board and law professor at Northwestern University, stated by affidavit that trades at the NBBO price satisfied the duty of best execution and that the general custom and practice of firms in the industry was to execute at the NBBO price [A225-27]. T. Grant Callery, General Counsel to NASD, also stated by affidavit that NASD views the NBBO price as satisfying the best execution duty [A 458]. Finally, Hugh Quiqley, a trader at Merrill

Lynch, declared that he had observed the trading practices of every major firm in the industry and observed that the standard practice was to trade at the NBBO [A 497].

Finally, while this case was pending on appeal, the SEC finalized new regulations pertaining to order execution which address directly the practices at issue here. *See generally* Self-Regulatory Organizations; National Association of Securities Dealers; Order Granting Partial Approval and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 to Proposed Rule Change Relating to Implementation of the Commission's Order Handling Rules, 62 Fed. Reg. 2415 (Jan. 16, 1997). Under these new rules, which became effective on January 20, 1997, market makers must display a customer's limit order when the price of that order is superior to the current NBBO quote. Moreover, any superior prices quoted on electronic communications networks such as SelectNet and Instinet must be listed as part of the NBBO price. *See* SEC News Release 97-3, *New Trading Rules for NASD and the Exchanges*, 1997 WL 21042 (Jan. 20, 1997). By these regulatory changes, dealers will essentially be required to eliminate the practices that appellants complain of in this case. We believe, as did the district court, that the fact that the Securities and Exchange Commission perceived the need to address these order execution practices through the regulatory process indicates strongly, if not conclusively, that the "duty" to cross orders and to look beyond the NBBO for pricing information was ambiguous, indeed speculative, during the class period. Regulatory agencies would not spend the time, money and effort in promulgating regulations if the duty it sought to impose were already clear under established law.[3]

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[3] We do not mean to imply, however, that the duty of best execution is in any way unenforceable in a private action under § 10(b) of the 1934 Act. Where the duty is clear, or where a practice is

III.

In sum, the evidence in this record is legally insufficient for a rational jury to infer that defendants failed to disclose their "NBBO-only" execution policy knowing that it was fraudulent not to do so, or that they recklessly ignored massive evidence suggesting that it was. Accordingly, the district court correctly found no scienter and properly entered summary judgment for defendants. We will affirm.

STAPLETON, *Circuit Judge*, dissenting:

During the class period, Section 10(b) and Rule 10(b)-5 (hereafter referred to collectively as "Section 10(b)") imposed upon the defendants a duty not to deliberately mislead their clients. The plaintiffs allege that, when the defendants received the plaintiffs' orders, the defendants knew both (1) that the plaintiffs expected them to execute these orders at a better price than the NBBO if the opportunity to do so presented itself, and (2) that the defendants themselves had no intention of referencing anything other than the NBBO. The issue for decision is whether the plaintiffs have produced sufficient evidence from which a trier of fact could reasonably infer that one or more of the defendants had this state of mind when they accepted the plaintiffs' orders for execution. I conclude that they have and that summary judgment for the defendants is therefore improper.

I.

The class period extends from November 4, 1992 to November 4, 1994. The district court granted summary judgment to the defendants primarily because the SEC, during that period, had not explicitly declared that the

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obviously fraudulent and not pervasive throughout the securities industry, the mere lack of regulations directly addressing the practice at issue will not constitute a bar to such a suit.

duty of best execution included the duty to consult reasonably available sources other than NBBO. Because resolving that issue involved considerations within the scope of the SEC's expertise, the district court believed it would be inappropriate for the courts to recognize a legal duty to consult other sources during the class period. I find the district court's approach unacceptable because it mistakenly equates the SEC's lack of guidance with an absence of any relevant law.

Our court reaches a somewhat different conclusion. It finds that the SEC's post-class period decision effectively eliminating the practices of which the plaintiffs here complain[1] "indicates strongly, if not conclusively, that the 'duty' to . . . look beyond the NBBO for pricing information was ambiguous, indeed speculative, during the class period." Slip Op. at 11. The court then concludes that there was applicable law during the class period and that it was established by the way in which a segment of the regulated profession behaved during that period. Thus, the defendants are entitled to summary judgment, we are told, because they have shown "that enough dealers [referenced only the NBBO during the class period] so that the duty to supplement the NBBO price [was] ambiguous and scienter is [therefore] negated." *Id.* at 10 (emphasis omitted).

I believe that Congress established the principles of law applicable here when it enacted Section 10(b) and that

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[1] The SEC proposed in 1995, and implemented in 1997, amendments to the "Quote Rule" which now require market makers to include in the NBBO any superior price they are quoting on electronic communications networks like SelectNet or Instinet. *See* Order Execution Obligations, Exchange Act Release No. 36,310, 60 Fed. Reg. 52972 (Oct. 10, 1995) ("Proposed Rules"); Order Execution Obligations, Exchange Act Release No. 37,619A, 61 Fed. Reg. 48290 (Sept. 12, 1996) ("Final Rules"). Since the new NBBO incorporates a far wider range of prices, the possibility of executing a trade at an inferior NBBO price when better prices are available on an electronic communications network has been eliminated.

these principles were not ambiguous during the class period. The district court's task was to apply those unambiguous principles to the circumstances of each transaction between a plaintiff and a defendant. Because there are material disputes of fact concerning those circumstances, I would reverse and remand for further proceedings.

II.

The relationship between a client and a broker is that of a principal and an agent. Absent special circumstances, it is a relationship in which it is understood by all that the client-principal seeks his own economic gain and the broker-agent earns his commission by helping the client-principal achieve that objective. Absent instructions to the contrary, the broker is thus expected to maximize the economic benefit to the client in each transaction. Hence, the duty of best execution.

"[T]he duty of best execution requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer's transaction." Proposed Rules, 60 Fed. Reg. at 52793; U.S. Equity Market Structure Study, Exchange Act Release No. 30,920, 57 Fed. Reg. 32587, 32595 (July 22, 1992); *see generally* Restatement of Agency (2d) § 424 (1958) (stating that agent must "use reasonable care to obtain terms which best satisfy the manifested purposes of the principal"). That is, the duty of best execution requires the defendants to execute the plaintiffs' trades at the best reasonably available price.[2] While there may be uncertainty in any

[2] Other terms in addition to price are also relevant to best execution. In determining how to execute a client's order, a broker-dealer should take into account order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. *See, e.g.*, Payment for Order Flow, Exchange Act Release No. 33,026, 58 Fed. Reg. 52934, 52937-38 (Oct. 13, 1993). When the plaintiffs state that better "prices" were reasonably available from sources other than the NBBO, I understand that to mean that, given an

particular situation as to what prices are reasonably available, the existence of a broker-dealer's duty to execute at the best of those prices that are reasonably available is well-established.

The set of prices that are reasonably available to a broker-dealer is constantly fluctuating. Therefore, determining what satisfies the duty of best execution is a highly fact-and-circumstance-sensitive inquiry, with the scope of the duty evolving over time with changes in technology and transformations in the structure of financial markets. *See, e.g.*, Final Rules, 61 Fed. Reg. at 48322-23. For example, before the creation of NASDAQ, a broker in an over-the-counter market satisfied her duty of best execution by contacting at least three market makers prior to executing a client's order. *See* Proposed Rules, 60 Fed. Reg. at 52793. With the advent of NASDAQ, and the NBBO computer system providing instant access to the best bid and offer available nationwide, the standard for satisfying the duty of best execution necessarily heightened.

The record reflects a genuine dispute of fact as to whether prices better than those on the NBBO were reasonably available from sources other than the NBBO at the time the defendants executed the plaintiffs' trades at the NBBO price. There is sufficient evidence from which a reasonable trier of fact could find, for example, that prices better than the NBBO were reasonably available on the SelectNet and Instinet at the very moment that the defendants chose to execute the plaintiffs' orders at the NBBO price. The defendants have suggested that consulting other sources besides the NBBO would have added

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evaluation of price as well as all of the other relevant terms, the trade would be better executed through a source of liquidity other than the NBBO (e.g. SelectNet, Instinet, in-house limit orders or market orders held by the defendants, or limit orders placed by the public in the Small Order Execution System). Similarly, for convenience, I use the phrase "best reasonably available price" to mean "best terms."

substantial expense and delay to the execution of plaintiffs' orders, more than offsetting any improvements that might have been available in terms of price. *See* Tr. Oral Arg. at 28-29. This, however, is clearly a factual dispute, which we are not permitted to resolve in favor of the defendants at this juncture.

I believe the evidence is sufficient to allow a reasonable trier of fact to conclude that, by the time of the class period, both technology and over-the-counter markets had developed to a point where it was feasible to maximize the economic benefit to the client by taking advantage of better prices than the NBBO.

III.

Recovery for federal securities fraud requires a showing of deliberate or reckless misrepresentation of a material fact. The misrepresentation here, according to plaintiffs, was an implied representation made by the defendants when they agreed to execute the plaintiffs' orders that they would maximize the plaintiffs' economic gain in the transaction. Plaintiffs' orders did not specify the price at which they were to be executed. It is at least a reasonable inference, plaintiffs therefore insist, that they would not have placed these orders with the defendants without an understanding that the defendants would execute them in a manner seeking to maximize plaintiffs' economic benefit. Since the defendants knew of the plaintiffs' profit motivation, they must have understood that plaintiffs would expect them to obtain a price more advantageous to the plaintiffs than the NBBO when one was readily available. If, as plaintiffs allege, the defendants intended not to act in a manner consistent with this expectation when they accepted the orders and yet did not so advise plaintiffs, the defendants can be found to have made an implied representation that they knew to be false.

In addition to these inferences that can be drawn from an economic analysis of the plaintiffs' relationship with

the defendants, plaintiffs rely upon evidence showing that respected members of the brokerage community recognized, even prior to the class period, that trades were readily available from sources other than the NBBO and that their clients expected them to take advantage of those sources whenever it would benefit the client. *See, e.g.*, Declaration of Paul M. Lacy [A 718]; Declaration of Junius W. Peake [A 755]; Declaration of Richard Y. Roberts [A 775]. Moreover, the plaintiffs have shown that the SEC found clear evidence of a two-tiered market during the class period, in which NASDAQ market makers routinely traded at one price with retail clients like the plaintiffs and at a better price for themselves through quotation services like SelectNet and Instinet. *See* Final Rules, 61 Fed. Reg. at 48307-08. They have further shown that the possibility that the duty of best execution might require resort to sources other than the NBBO was being actively debated during the class period and that that debate ultimately resulted, after the class period, in a regulation effectively requiring as much. *Id.*

All of this would allow a reasonable trier of fact to find that the defendants' misrepresentation—namely, that they would execute plaintiffs' trades in a manner maximizing plaintiffs' economic gain—was at least reckless, if not intentional. *See Healey v. Catalyst Recovery of Penn., Inc.*, 616 F.2d 641, 649 (3d Cir. 1980) (defining recklessness as an extreme departure from ordinary care). Certainly, then, scienter can be found on this record.

To be sure, as the court's opinion stresses, the defendants have countered with affidavits of other respected members of the brokerage community stating that their practice during the class period was the same as that of the defendants. This evidence could, of course, be regarded by a trier of fact as probative of the defendants' state of mind when they accepted plaintiffs' orders. But these affidavits do no more than raise a material issue of

fact as to whether the defendants knew of the expectation plaintiffs claim to have had; they do not settle the matter.

At trial, the defendants would certainly be entitled to argue to the jury that, because of industry practice, they thought their clients would expect them to execute only at the NBBO or that they never thought about their clients' expectations. Moreover, any evidence, derived from knowledge of industry practice or elsewhere, that the plaintiffs were generally aware of the defendants' exclusive reliance on the NBBO would, of course, be quite probative of whether the plaintiffs had the expectations they claim. But the court, in elevating the practice of a segment of the industry to be outcome determinative, loses sight of the fact that the basis for the duty of best execution is the mutual understanding that the client is engaging in the trade—and retaining the services of the broker as his agent—solely for the purpose of maximizing his own economic benefit, and that the broker receives her commission because she assists the client in reaching that goal. Based on this mutual understanding and the absence of any express limitations on the brokers' responsibility, a trier of fact could find that the defendants understood that they were expected to utilize sources other than the NBBO when a better price was readily available.

IV.

As I understand the court's analysis, a Section 10(b) defendant might be granted summary judgment even if her regular practice violated the duty of best execution, and she knew or should have known that it violated that duty, so long as she can identify a sufficient number of other broker-dealers engaged in the same wrongful conduct to be able to argue in good faith that the underlying duty was "ambiguous." I cannot accept an analysis that will produce such a result.

Even a universal industry practice may still be fraudulent. *See Chasins v. Smith, Barney & Co.*, 438 F.2d 1167,

1171-72 (2d Cir. 1970) (non-disclosure of widespread industry practice may still be non-disclosure of material fact); *Opper v. Hancock Securities Corp.*, 250 F. Supp. 668, 676 (S.D.N.Y. 1966) (industry custom may be found fraudulent, especially on first occasion it is litigated); *see also Vermilye & Co. v. Adams Express Co.*, 88 U.S. 138, 146 (1874). Indeed, the SEC recently completed an investigation in which it found that widespread fraud was occurring in the NASDAQ market during a period overlapping the class period. *See* Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market (Aug. 8, 1996).

As the court emphasizes, the practice of exclusive reliance on the NBBO has never been held to be fraudulent by any court or regulator. But neither is there any statute, rule, regulation, or interpretation, by the SEC or by a court, that authoritatively establishes that exclusive reliance on the NBBO, even when better prices are reasonably available, satisfies the duty of best execution. Whether the NBBO exhausted the category of "reasonably available prices" during the class period has thus never been expressly determined. But this did not absolve the district court of the duty to resolve the plaintiffs' securities fraud claim once it was presented in this suit.

"In the final analysis, ultimate responsibility for construction and enforcement of the securities laws must rest with the court." *Langert v. Q-1 Corp.*, Fed. Sec. L. Rep. (CCH) para. 94,445, at 95,540, 1974 WL 377 (S.D.N.Y. Mar. 15, 1974). The district court was not deprived of this enforcement authority just because no court or regulator had previously chosen to exercise such authority with respect to the practice challenged here. *See, e.g., Chasins*, 438 F.2d at 1171-72 (finding that defendant's failure to disclose its market maker status was material omission under Section 10(b), despite fact that SEC had never previously held that such disclosure was required).

V.

On the record before us, I believe a reasonable trier of fact could conclude that the defendants misrepresented that they would execute the plaintiffs' orders so as to maximize the plaintiffs' economic benefit, and that this misrepresentation was intentional or reckless because, at the time it was made, the defendants knew that they intended to execute the plaintiffs' orders at the NBBO price even if better prices were reasonably available. A reasonable trier of fact could find scienter with respect to a material misrepresentation, as well as the other elements essential to a Section 10(b) fraud claim. Accordingly, I must respectfully dissent.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX C

Opinion and Order of the United States District Court for the District of New Jersey, *In re Merrill Lynch, et al. Securities Litigation*, 911 F. Supp. 754 (Dec. 15, 1995)

[Filed Dec. 15, 1995]

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civ. No. 94-5343 (DRD)

IN RE MERRILL LYNCH, *et al.*
SECURITIES LITIGATION

OPINION

Debevoise, Senior District Judge.

This is a class action in which the complaint charges defendant brokerage firms with securities fraud in violation of Section 10 of the Securities Exchange Act of 1934 and Rule 10-b promulgated thereunder, as well as breach of fiduciary duty and unjust enrichment under state law. Defendants moved to dismiss the complaint for failure to state a claim upon which relief can be granted. At the direction of the court defendants' motion was converted into a motion for summary judgment. Defendants were requested to supply by way of affidavit and supporting documents information relating to each transaction which they conducted on behalf of each of the plaintiff class representatives during the class period. In addition, each party was requested to submit information about market practices and regulatory requirements or advisories concerning transactions such as those which were the subject of the complaint. For the reasons given below, defendants' motion for summary judgment is granted.

I—PLAINTIFF'S ALLEGATIONS

Defendants in this case, Merrill Lynch Pierce Fenner & Smith, Inc. ("Merrill Lynch"), PaineWebber, Inc. ("PaineWebber") and Dean Witter Reynolds, Inc. ("Dean Witter"), are "integrated broker/dealer" brokerage companies that transact trades both as agents and as principals. Plaintiffs Bruce Zakheim IRA FBO Bruce Zakheim ("Zakheim"), a Merrill Lynch customer, Gloria Binder ("Binder"), a Painewebber customer, and Jeffrey Phillip Kravitz ("Kravitz"), a Dean Witter customer retained defendants to either conduct trades on their behalf or to trade with them directly in various over-the-counter ("OTC") securities.

The gravamen of plaintiffs' complaint is as follows:

1) As agents, defendants relied exclusively on the National Best Bid and Offer ("NBBO"), a price quotation representing the best bid and best offer of any OTC market maker in a particular security on the two-sided NASDAQ market, to fulfill their duty to execute their customers' market orders [1] at the best available price, despite the availability of better prices from a number of sources of liquidity. Those sources included SelectNet [2], Instinet [3], in-house limit orders, in-house market orders, and the SOES limit order file.[4] Plaintiffs contend that by failing to take advantage of these other sources and by failing to disclose such neglect, defendants breached a

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[1] An instruction from a retail customer to buy or sell securities at the best available market price that is distinguished from a "limit order," an instruction to buy or sell at a particular price, specified by the customer.

[2] An on-line trading system provided by NASDAQ. *See infra* at p. 10.

[3] Institutional Networks, Inc., a proprietary on-line trading system. *See infra* at p. 11.

[4] Small Order Execution System Limit-Order Service. *See infra* at p. 12.

fiduciary duty they owed to plaintiffs by dint of the broker/customer relationship that existed between them. Amended and Consolidated Class Action Complaint ("Amended Complaint") ¶¶ 25-32, 46-49.

2) As principals, defendants not only failed to execute plaintiffs' market orders at the best available price but also employed a number of fraudulent devices to secretly accrue profits for themselves. Failure to disclose both the accrual of such profits and the practice of failing to execute at the best available price, according to plaintiffs, amounted to fraud, Amended Complaint ¶ 42, and a further violation of defendants' fiduciary duty. Amended Complaint ¶ 48. Moreover, defendants were unjust enriched by the accrual of secret profits. Amended Complaint ¶¶ 50-53.

The parties agree that all the transactions in question here were executed by defendants, either as agents or principals, at prices that were equivalent to the NBBO at the time of each transaction. Amended Complaint ¶ 28; Memorandum of Law In Support of Defendants' Motion to Dismiss the Amended Complaint at 7-8; Reply in Support of Defendants' Motion To Dismiss The Amended Complaint at 2; Declaration of Hugh Quigley ¶ 10; Affidavit of Robert Slane ¶ 9; Affidavit of Thomas Dwyer ¶¶ 6-8.

The fraudulent devices alleged by plaintiffs to have been employed by the defendants in their role as principals, are as follows:

> 1) *Failure to reference sources other than the NBBO when setting prices, as principals, for transactions with retail customers:* By setting the price of their transactions as principals with reference exclusively to the NBBO, defendants arbitrarily made parity with the NBBO the de facto standard for best execution. Because prices superior to the NBBO, from the standpoint of the retail customer, were in

fact available from other sources of liquidity at the time of those transactions, defendants were able to establish market positions, both long and short, that were, in fact, better, from their standpoint, than those that represented the "best available price" at any given time. By establishing such superior positions, defendants were able to profit from the difference between the NBBO and the best available price. Amended Complaint ¶ 33.

2) *Failure to cross in-house market orders:* Plaintiffs contend that when defendants received contemporaneous market orders to buy and sell shares in the same stock they systematically failed to execute those orders at a price between the bid and ask, executing each instead at the NBBO quote, thereby appropriating the "spread" between the bid and asked prices on the two-sided NASDAQ market while incurring no risk to themselves. Amended Complaint ¶¶ 34-35.[5]

3) *Failure to cross customers' market orders with in-house limit orders:* Plaintiffs contend that defendants executed customers' market orders at the NBBO despite having received corresponding "limit" orders in the same security from other customers. Defendants thereby appropriated the "spread" while incurring no risk to themselves. Amended Complaint ¶ 36

4) *Failure to cross customers' market orders with SOES limit orders:* executing orders to either sell or

[5] Plaintiffs distinguish between situations in which balanced numbers of buy and sell orders are received, Amended Complaint ¶ 34, and situations in which unbalanced orders were received, *Id.*, ¶ 35. The same failure to cross market orders is alleged in both cases. The difference is that in the unbalanced case, defendants are alleged to have taken advantage of another fraudulent device, using the NBBO rather than a better available price on SelectNet or Instinet, with respect to the remaining shares.

buy shares of particular stocks at the NBBO despite the currency of "limit" orders on the SOES limit order file.[6]

5) *Re-trading at the inside price on the "same side" of the spread:* executing market orders to either sell or buy shares of particular stocks at the NBBO quotes despite better prices being available, and then immediately retrading those same shares at those better prices for defendants' own profits, incurring no risk by trading on the same side of spread. Amended Complaint ¶ 37.

6) *Selling order flow:* Without knowledge or consent of the customers placing the orders and in exchange for payments ("payment for order flow"), defendants allegedly routed plaintiffs' market orders to other brokers who failed to execute them at the best available price and who used one or more of the above fraudulent devices to secretly accrue profits to themselves. Amended Complaint ¶ 38.

Plaintiffs bring this class action pursuant to Fed. R. Civ. Proc. 23 on behalf of all those persons who placed market orders with Merrill Lynch, PaineWebber or Dean Witter to purchase or sell shares of OTC stock between November 4, 1992 and November 4, 1994.

II—MARKET OPERATION

NASDAQ

Over-the-counter trading ("OTC") is, in a sense, the oldest and simplest type of economic exchange: buyer

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[6] This device was not alleged in the Amended Complaint. Plaintiffs introduced it in papers supplied in compliance with the court's order converting the motion to dismiss into a motion for summary judgment. Plaintiffs' Supplemental Memorandum at 5; Declaration of Haim Mendelson, ¶ 17(iv) at 9.

and seller meet outside a formal marketplace, agree on a price and exchange items of economic value. The term derives from a time, long before the advent of computers and electronic communications networks, when some trading in stocks took place in banks where the physical certificates were passed "over-the-counter." *Reshaping The Equity Markets,* Robert A. Schwartz at 47 (Harper-Business 1991) [hereinafter Schwartz].

In 1971, in an effort to link together geographically dispersed dealers into a single integrated system by exploiting rapidly evolving technologies, Congress created the National Association of Securities Dealers Automated Quotation System ("NASDAQ,", more formally the Nasdaq Market System, Inc.), a subsidiary of The National Association of Securities Dealers ("NASD"). The purpose of the NASDAQ was explicitly delineated in the authorizing legislation:

> The securities markets are an important national asset which must be preserved and strengthened . . . The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.

15 U.S.C. § 78k-1(a)(1)(A) and (D).

The function of a stock exchange is to provide an environment in which the transfer of capital between enterprises can be accomplished at fair prices for minimal cost. One measure of the success of an exchange in fulfilling that role, known as liquidity, is the rapidity and ease with which such transfers can be effectuated. An marketplace with good liquidity affords buyers and sellers the opportunity to locate counterparts willing to trade a wide range of issues at acceptable prices as quickly and efficiently as possible.

In contrast to traditional markets, where liquidity, and thus efficiency and immediacy, are maintained by monopolist "specialists," liquidity on the NASDAQ is maintained by competing dealers, known as "market makers," who hold themselves out to all comers as ready to buy or sell a security for their own account. By making known the price at which they are willing to transact in a particular stock, NASDAQ market makers create a competitive structure in which fair prices are arrived at quickly and efficiently.

To maintain this liquid environment market makers must put their own capital at risk. In order to "foster the risk-taking function of market makers and thereby . . . provide free market incentives to active participation in the flow of orders," *Securities Acts Amendments of 1975*, Report of the Committee on Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. at 12 (1975), market makers are therefore permitted to buy securities at a "bid" price and to sell them at a higher "ask" price, thus creating what is known as a "two-sided" market. *Plastis v. E.F. Hutton*, No. G86-1030 CA5, 1990 U.S. Dist. LEXIS 4828 (W.D. Mich. Apr. 18, 1990) ("The difference between [the bid and offer] is known as the 'spread,' and represents the market maker's compensation for the transaction."); *Investors Research Corp.*, 1976 SEC LEXIS 2771 (July 19, 1976) ("The spread is [the market maker's] compensation for 'dealing' in a security and risking its capital.").

The NBBO

SEC rules require that any NASDAQ dealer that wishes to hold itself out as a market maker in a particular security must continually report the prices at which it is willing to buy and sell the security. 17 C.F.R. § 240.11Ac1-1 (c)(1). Once reported, those quotes must be honored up to the "quotation size" ("[t]he number of shares . . . that [a market maker] is willing to buy at the bid price or sell

at the offer price comprising his bid or offer. . ." 17 C.F.R. § 240.11Ac1-1(a)(10)), 17 C.F.R. § 240.11Ac1-1(c)(2).

NASDAQ itself is required to "collect, process and make available . . . the highest bid and lowest offer communicated . . . by each member . . . acting in the capacity of an OTC market maker for each reported security . . ." 17 C.F.R. 240.11Ac1-1(b)(1)(ii). This quotation has come to be known as the National Best Bid and Offer ("NBBO").

In accordance with this obligation, NASDAQ operates a quotation reporting system which disseminates market maker quotes over an electronic communications network. There are three levels to this service:

> Level 1—Displays the best bid and ask quotes, high, low and last prices and volumes. Does not reveal origin of quotes.
>
> Level 2—Displays the current quotes and the names of the market makers who have entered them.
>
> Level 3—Displays the same information as Level 2 and also allows market makers to enter and to update their quotes.

SelectNet

Introduced in November, 1990, SelectNet is an on-line service provided by NASDAQ on which subscribers can negotiate trades and execute orders in OTC securities. In addition to price, offers posted by subscribers can specify size, the period during which the offer is "open," (any period up to 99 minutes or an entire day), and whether the price or size of an order is negotiable. Subscribers may also "preference" their orders, that is, an order may be directed at a specific market maker, at all market makers, or at all subscribers. Offers may be accepted, countered or declined. Subscribers who are not market makers

may make their offers anonymously. Market makers must identify themselves.

The thrust of the SelectNet service is to provide an electronic alternative to negotiation by telephone. "The system is offered to NASD members to facilitate negotiation of securities transactions through computer automation, rather than relying on telephone communication." *Market 2000, An Examination of Current Equity Market Developments*, Division of Market Regulation of the SEC, Section IV at 6-7, 1994 SEC LEXIS 135 at *8 (1994) (hereinafter *Market 2000*)

Instinet

Institutional Networks, Inc. ("Instinet") is another online trading system, similar to SelectNet but differing in two important aspects: 1) it is privately owned and operated; and 2) subscribers, including market makers, may display offers and trade *anonymously*. Traders, particularly large institutions, may therefore conduct large transactions without any revelation of their identity that might induce market reaction against their interest. Orders are accepted from a minimum of 1000 shares to a maximum of 50,000 shares. Although it conducts trades on behalf of clients, Instinet is not a market maker and therefore does not risk its own capital, charging only a commission for its services. *Instinet Corp.*, SEC No-Action Letter, 1992 WL 672345 (S.E.C.) at *2.

SOES Limit Order File

In response to the general sentiment that retail customers were not obtaining execution at the best possible price, the SEC created the Small Order Execution System ("SOES") in December, 1984. Participation in SOES was made mandatory for market makers after the October 1987 crash. Sec. Ex. Act Rel. 25,791, 42 SEC Dock. 91 (1988); Sec. Ex. Act Rel. 26,650, 43 SEC Dock. 790 (1989). Automatic execution on SOES provides small

cusotmers with the opportunity to consistently obtain the NBBO by automatically routing orders to the market maker with the best posted bid or offer.

In January, 1989, the SEC introduced the Limit-Order Service, an extension of SOES. The SOES limit book file, as this service came to be known, allows both GTC (good till canceled) and day limit orders of one thousand shares or less to be accepted, stored, and automatically executed when a market maker's quote reaches or exceeds a limit order price. A small customer can therefore be assured of obtaining execution at a given price if the market, in the form of the NBBO, reaches that level.

In-house limit and market orders

Individual integrated firms, functioning as either agents or principals, receive orders to both buy and sell securities in the course of the trading day. When either a limit or market order is received before a "corresponding" order is executed, the possibility exists that the two orders could be matched, or "crossed" at a price midway between them. "Call market" trading systems employed in some foreign countries, e.g., Austria, Belgium, Germany and Israel, as opposed to "continuous" trading systems employed on the United States financial markets (both securities exchanges and the OTC markets), regularly utilize this type of order crossing by periodically batching corresponding offers for simultaneous execution at a single "clearing" price:

> "[O]rders for an issue are revealed to an auctioneer when the market is called. Buy and sell orders are matched at the price that most closely equates the aggregate number of shares offered for sale (at that price and below) with the aggregate number of shares sought for purchase (at that price and above). Then, all market orders to buy and all buy limit orders at the clearing price or higher are executed, as are all market orders to sell and all sell limit orders at the clearing price or lower."

Schwartz at 181.

It is the contention of plaintiffs in this action that defendants were obligated to conduct such a call market whenever an outstanding market or limit order remained unexecuted upon receipt of corresponding market order. Amended Complaint ¶¶ 34-36.

Duty of Best Execution

The relationship between a broker/dealer and its customer gives rise to "certain fiduciary obligations." *In re E.F. Hutton & Co.*, Securities Exchange Act Release No. 25887, [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, 89,326 at 89,328 and n.9 (July 6, 1988) (citing Restatement (Second) of Agency ¶ 1 (1957)). Amongst those obligations is a duty to execute the customer's order at the best available price. *Payment For Order Flow*, Exchange Act Release No. 34902 [1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,444, 85,849 at 85,854 n.28. ("*Payment for Order Flow Release No. 34902*"). That agency obligation, moreover, does not dissolve when the broker/dealer acts in its capacity as a principal. "A broker/dealer's determination to execute an order as a principal or agent cannot be 'a means by which the broker may elect whether or not the law will impose fiduciary standards upon him in the actual circumstances of any given relationship or transaction.'" *In re E.F. Hutton* at 89,328 (quoting *Opper v. Hancock Securities Corp.*, 250 F.Supp. 668, 675 (S.D.N.Y.), *aff'd*, 367 F.2d 157 (2d Cir. 1966)). Avoidance of any conflict of interest is central to public confidence in the various markets. "The integrity of the industry can be maintained only if the fundamental principle that a customer should at all times get the best available price which can reasonably be obtained for him is followed." *The Report Of The Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. II, 624 (1963).

The central issue in this case is precisely what is entailed by the duty of best execution. Any act done in good

faith in conformity with an SEC rule cannot result in liability under Section 10 (Manipulative and Deceptive Devices and Contrivances). 15 U.S.C. § 78w(a)(1) ("No provision of this chapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission . . . [or] any self-regulatory organization . . ."). The Second Circuit has extended this doctrine to the Commission's interpretations of its own rules. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1294 (2d Cir. 1973). Failure to comment or a no-action letter from the SEC does not constitute an interpretation by the Commission. *SEC v. Falstaff Brewing Corp.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 96,583, at 94,473 (D.D.C. 1978), *aff'd* 629 F.2d 62 (D.C.Cir.), cert. denied sub nom. *Kalmanovitz v. SEC*, 449 U.S. 1012 (1980); *Langert v. Q-1 Corp.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. § 94,445, at § 95,540 (S.D.N.Y. 1974).

The difficulty here is that neither Congress, the SEC nor the NASD has issued a definitive statement on point concerning the use of the NBBO as statisfaction of the duty of best execution.[7] Lacking such a pronouncement, the parties rely on various sources of to bolster their respective interpretations of the content of that duty as it existed during the class period.

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[7] Plaintiffs fail to allege any damage based on their "cross trades" theories. *See infra* at pp. 27-28. Accordingly, the discussion here is confined to those counts of the Amended Complaint that concern adherence to the NBBO. Amended Complaint ¶¶ 30-33, 37 and 39-53.

The theory of damage contained in Count 38 of the Amended Complaint, concerning payment for order flow to firms that allegedly were guilty of the same fraudulent conduct as defendants, is dependent on plaintiffs' primary theories of damage. Accordingly, the discussion here is confined to the underlying damage theories.

Defendants' Best Execution Sources

In support of their contention that the duty of best execution is categorically satisfied by reference the NBBO defendants cite the following sources:

1) The NASD Manual: "In any transaction for or with a customer, a [broker-dealer] . . . shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing conditions." *Interpretation of the Board of Governors on Execution of Retail Transactions in the Over-The-Counter Market,* NASD Rules of Fair Practice, Art. III, Section 1, NASD Manual (CCH) ¶ 2151.03.

Defendants contend that the NASDAQ Level 2 was the "best inter-dealer market" and the NBBO was the most favorable "resultant price." Memorandum of Law In Support of Defendants' Motion To Dismiss The Amended Complaint at 18.

2) An investigatory report compiled by the SEC's Division of Market Regulation: "[I]t is reasonable to accept quote-based executions of market orders based on the NASDAQ best bid or offer as consistent with best execution, absent customer instructions to the contrary." *Market 2000,* Study V at 5, 1994 SEC LEXIS 136 at *15.

3) An SEC regulation on the SOES system: "SOES orders are executed in rotation against [] market makers at the inside bid or ask." *Self-Regulatory Organization; National Association of Securities Dealers, Inc.,* Exchange Act Release No. 34-33377, 58 Fed. Reg. 69419 (Dec. 23, 1993). Defendants contend that SEC sanction of the SOES system, with its automatic execution at the NBBO, implies SEC approval of use of SOES to satisfy best execution. Defendants' Memorandum Of Law In Support Of Motion To Dismiss at 21. Plaintiffs counter that use of

SOES satisfies best execution only when a broker/dealer has diligently ascertained that a better price is not available: "[A] broker-dealer routing customer orders for automated execution could satisfy its best execution obligations so long as the broker-dealer assesses periodically the quality of competing markets . . ." Plaintiff's Memorandum Of Law In Opposition To Defendants' Motion To Dismiss The Amended Complaint at 33-34 and *Payment For Order Flow Release No. 34902* at 85,854.

4) A report to the Board of Governors of the NASD: "[The committee] believes that when orders are executed at the best current displayed bid or offer that investors receive best execution of their small-sized orders. . ." *Inducements for Order Flow,* A Report to the Board of Governors, National Association of Securities Dealers at 28 (July 1991). Plaintiffs contend the SEC expressly disavowed this statement, noting that "such interpretation of best execution in all circumstances may not be consistent with previous statements of the Commission regarding best execution." *Payment for Order Flow,* Exchange Act Release No. 33206 [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,234, at 84,542 n.29 (Oct. 6, 1993).

5) The affidavit of the General Counsel of the NASD: "The NASD has viewed [execution at the NBBO] as consistent with the duty of 'best execution' that broker-dealers assume when they accept customer orders" Declaration of T. Grant Callery, ¶ 4. "The NASD has not in the past adopted any rules that required market makers to 'cross' market orders with in-house limit orders rather than execute those orders at the NBBO The NASD also has not required market makers to seek execution of market orders at prices reflected in the Instinet or SelectNet system." *Id.*, ¶ 5.

6) The affidavit of a former chairman of the SEC: "It has long been the understanding in the securities industry that investors receive best execution when their small OTC orders are executed at the NBBO. It is the

general custom and practice of firms in the industry to execute such orders at the NBBO." Affidavit of David S. Ruder, ¶ 3.

Plaintiffs' Best Execution Sources

In support of their contention that defendants were obligated to look beyond the NBBO when satisfying the duty of best execution which they owed to their retail customers, plaintiffs cite the following:

1) An SEC report to Congress: "For a firm which executes customer orders from an inventory accumulated in the course of making a market . . . its obligation in checking markets involves reasonably assuring that the customer pays or receives a net price not disadvantageous in respect of the price available elsewhere." *The Report Of The Special Study of Securities Markets,* H.R. Doc. 95, 88th Cong., 1st Sess. Pt. II, 616 (1963).

2) Two SEC regulations regarding payment for order flow: "[While] brokers have not been held . . . to an absolute requirement of achieving the most favorable price on each order[,] [w]hat has been required is that the broker endeavor, using due diligence, to obtain the best execution possible given all the facts and circumstances." *Payment For Order Flow,* Exchange Act Release No. 33206 [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,234, 84,536 at 84,541 (Oct. 6, 1993) (quoting *Second Report on Bank Securities Activities: Comparative Regulatory Framework Regarding Brokerage-Type Services* 97-98, 98 n.233 (Feb. 3, 1977) *as reprinted in* Senate Comm. on Banking, Housing and Urban Affairs, 95th Cong., 1st Sess., *Report on Bank's Securities Activities of the SEC* 145, 251-52, 252 n.233 (Comm. Print 1977).

"[T]he Commission's staff recently has warned against presuming that guaranteed executions at the best bid or offer always will satisfy the broker-dealer's best execution duties for small orders in listed securities." *Payment For*

Order Flow Release No. 34902 at 85,849 (referring to *Market 2000*, Study V at 4).

3) An NASD Notice to Members: "[I]f the market maker executes trades immediately surrounding its retail sales, such as comparable sales to a non-market maker at a price lower than the inside ask, the use of these actual sale prices may be required to arrive at the prevailing market price." *Special NASD Notice to Members Re: Policies and Procedures For Markups,* 1992 NASD LEXIS 47 at *14 (Apr. 1, 1992).

4) The affidavit of a former member of the Board of Governors of the NASD: "[I]t is my understanding and opinion that a broker-dealer's execution of a customer market order at the NBBO when superior prices are otherwise reasonably available does not comport with the duty of best execution." Declaration of Junius W. Peake, ¶ 5.

5) The affidavit of a former Commissioner of the SEC: "It is my opinion, during the Class Period, absent customer instructions to the contrary, a broker-dealer failed to fulfill its duty of best execution to a customer if the broker-dealer did not execute the customer's order at a reasonable available superior price, including such a price available on Instinet or SelectNet . . . and instead executed the order at the NBBO." Declaration of Richard Y. Roberts, ¶ 7.

6) The affidavit of a retired OTC securities trader: Paul M. Lacy was an over-the-counter trader for thirty-two years prior to his retirement in 1990. "[I]n order to meet [the fiduciary obligation to obtain the best price available], before I executed any market order for a retail customer to buy or sell OTC securities in which [my employer] made a market, in addition to monitoring the NBBO price displayed on NASDAQ, it was my custom and practice to check prices available from alternative sources including (1) any open orders for that security;

(2) any day orders for that security; (3) other in-house market orders for the same security that could be crossed; and (4) contacts with fellow traders at competing broker-dealers firms . . . Beginning in the late 1980's . . . I began also to check Instinet quotations prior to executing any retail customer market orders to buy or sell the NASDAQ stocks in which I made a market." Declaration of Paul M. Lacy, ¶¶ 5 and 8.

The parties contentions notwithstanding, none of these sources represents a law, regulation or interpretation of a regulation which directly addresses the question of whether or not a broker/dealer's duty of best execution was satisfied by exclusive reference to the NBBO during the class period. While these statements may be helpful, absent an unequivocal pronouncement on point, it must be independently determined whether circumstances as they existed during the class period imposed a standing obligation on the defendants to refer to sources other than the NBBO in fulfilling the duty of best execution that they owed to plaintiffs, and, if so, whether failure to refer to such other sources, *ipso facto,* constituted securities fraud.

III—PROPOSED RULES ANNOUNCED SUBSEQUENT TO THE CLASS PERIOD

SEC Proposed Rules—Order Execution Obligations

Both parties point to the recent release of a set of proposed rules by the SEC in support of their interpretation of broker obligations existing during the class period.

On September 29, 1995, the SEC proposed rules that would amend Rule 11Ac1-1 to require market makers to include "any better prices that they quote privately through certain electronic communications networks" in their best bid and offer quote. "The [proposed] amendments are designed specifically to address what the Commission believes to be the potential for market makers to quote one price to public investors but to publish firm quotes in

private systems at better prices." *Order Execution Obligations—Proposed Rules,* SEC Release No. 34-36310 at 22, (Sept. 29, 1995) (hereinafter *Order Execution Obligations*).

The proposed rule does not directly comment on satisfaction of the duty of best execution through use of the NBBO. "The rules proposed today . . . are not intended to alter or displace the well-established duty under the antifraud principles for market participants to provide customers with best execution." *Id.* at 10. Instead, the intended effect is achieved by modifying the NBBO itself: reference to the "new" NBBO will produce prices equivalent to the best available prices the broker/dealer is offering not only on the NASDAQ Level 2, but on SelectNet and Instinet. *Id.* at 22.

The proposed rule is explicitly prospective. "The Commission is proposing to include *prospectively* within the definition of 'bid' or 'offer' under the Quote Rule priced orders that market makers enter into widely disseminated electronic communications networks, thereby requiring market makers to include such orders in the bids and offers they communicate to their exchange or association for reflection in their published quotations." *Id.* at 24.

Also included in the proposed rule is a requirement that exchange specialists and OTC market makers include in-house customer limit orders in the determination of their published quotes. *Id.* at 40. By requiring dealers to "expose" their customers' limit orders, thereby incorporating them into the NBBO, the SEC has proposed to implement a practice which plaintiffs contend defendants were obligated to follow during the class period. Amended Complaint ¶ 36.

NASD Proposed Rule—NAqcess

Plaintiffs also point to the release of a proposed rule change by the NASD, seeking to set up a small order

execution system to supersede SOES. The new system, entitled "NAqcess," would provide greater protection for the public's limit orders and afford public market orders the opportunity for price improvement, the ability to transact "between the spread" at purchase prices lower than the inside "ask" price, and sale prices higher than the inside "bid" price, by allowing customers to specify that an order be entered into NAqcess where it would interact with other limit and market orders without the participation of a market maker. *Proposed Rule Change*, File No. SR-NASD-95-42, National Association of Securities Dealers at 3-4 (Sept. 18, 1995).

The proposed rule parallels plaintiffs contention that defendants should have allowed in-house limit and market orders to interact without defendants' participation. Amended Complaint ¶¶ 34-36.

Defendants assert that the prospective nature of both pronouncements is supportive of their contention that no obligations similar to those described in the new rules existed prior to their proposal by the SEC and NASD. Defendant PaineWebber's Supplemental Brief In Support Of Motion For Summary Judgment at 14-16.

IV—SPECIFIC TRANSACTIONS

Thirteen trades were conducted by defendants on behalf of plaintiff class representatives during the class period. The details of those transactions are as follows:

Trans. Date	*Defendant*	*Plaintiff*	*Role*	*Type*	*Shares*	*Security*	*Price*
Aug 19, 1993	PaineWebber	Binder	agent	purchase	7000	Hydron Tech.	2 9/16
Apr 21, 1994	PaineWebber	Binder	agent	purchase	1000	Optical Radiation	20
July 18, 1994	PaineWebber	Binder	agent	sale	1000	Optical Radiation	22 1/4
Nov 10, 1993	Dean Witter	Kravitz	agent	purchase	100	Cellular	28
Nov 10, 1993	Dean Witter	Kravitz	agent	sale	262	IDB Comm.	45
Oct 20, 1993	Dean Witter	Kravitz	agent	purchase	100	Iwerks	34 3/4
Sept. 21, 1994	Dean Witter	Kravitz	agent	purchase	100	Safety Components	19
Aug 25, 1993	Dean Witter	Kravitz	agent	purchase	100	Scientific Games	18
Feb 11, 1994	Dean Witter	Kravitz	agent	purchase	100	Simpson Industries	22 1/2
Feb 1, 1994	Dean Witter	Kravitz	princ.	purchase	100	Envoy	19 1/4
Dec 29, 1993	Dean Witter	Kravitz	princ.	sale	100	Spectrum	7 1/2
June 7, 1994	Merrill Lynch	Zakheim	princ.	purchase	120	US Healthcare	42 3/4

Defendants acted as market makers in three of the thirteen transactions: plaintiff Kravitz's Feb. 1, 1994 and Dec. 29. 1993 transactions with Dean Witter and plaintiff Zakheim's June 7, 1994 transaction with Merrill Lynch. The remaining ten transactions were conducted by defendants as agents. Only those counts of the complaint which address defendants' conduct as agents, that is, those counts that allege failure to obtain the best available price and the fraudulent sale of order flow to market makers who in turn derived secret profits, Amended Complaint ¶¶ 30-31 and 38, are applicable to the remaining ten transactions.

Damage (if the plaintiffs' theory of liability is accepted) is definitively shown in only one transaction:

Plaintiff Binder's April 21, 1994 purchase order for 1000 shares of Optical Radiation was placed by defendant PaineWebber, as agent, with Prudential Securities, a market maker in Optical Radiation stock. Affidavit of Thomas Dwyer, ¶¶ 2 and ¶ 7. Prudential entered the order at 14:22:54 and executed the transaction approximately 6 minutes later, at 14:29:00, for a price of 20. *Id.*, Exhibit 2 at 1. A "day" offer, that is, an offer that is good for the entire trading day, to sell 2000 shares of Optical Radiation in blocks of 1000 shares at 19¾ was broadcast on SelectNet to all market makers in that security at 10:19:06. Certification of Karen L. Barr, Exhibit A at page "2357." As a day order broadcast to all market makers, that order was available to Prudential Securities. Because Prudential executed Binder's order at the NBBO of 20 rather than accepting the open SelectNet day offer at 19¾, Binder was charged ¼ more per share than she would have had the SelectNet offer been accepted. The resulting net damage was $25 on the 1000-share transaction. Failure to disclose the routing of a market order to another brokerage firm that executed the order at the NBBO while a superior price was available on SelectNet constitutes the type of conduct which plaintiffs allege is a fraud. Amended Complaint ¶¶ 31 and 38.

In two other transactions there is evidence of damage of a more indirect, somewhat speculative nature:

1) Plaintiff Binder's August 19, 1994 purchase order for 7000 shares of Hydron Technologies was placed by defendant PaineWebber with Reich & Co., a current market maker in Hydron Technologies. Affidavit of Thomas Dwyer, ¶¶ 2 and 6. Reich & Co. entered the order at 13:31:00 and executed it approximately 17 minutes later at 13:48:28 at a price of 2 9/16. *Id.*, Exhibit 2 at 2. An offer preferenced to Lehman Bros. (and therefore not available to Reich & Co.) to sell any quantity of Hydron Technologies up to 3000 shares at a price of 2½ was entered on SelectNet at 13:30:32. The offer was good for three minutes. Certification of Karen L. Barr, Exhibit A, page "1338." Plaintiffs contend that the existence of the Lehman Bros. offer, although not available to Reich & Co. should have served as the reference price by which Reich set the price of its own transaction with Binder. "[T]he contemporaneous availability of a superior price on SelectNet, although not available for Binder's order, indicates that a superior price may have also been available on Instinet." Reply Declaration of Haim Mendelson, ¶ 33 at 13-14. The differential of 1/16 between the NBBO and preferenced SelectNet price resulted in net damage to Binder of $437.50 on the 7000-share transaction.

2) Plaintiff Zakheim's June 7, 1994 purchase order for 120 shares of U.S. Healthcare was executed by defendant Merrill Lynch, as principal, at 11:11:54 for a price of 42¾. Twenty-nine of Merrill Lynch's thirty-four trades in USHC conducted on June 7, 1994 on Instinet were executed at prices better than NBBO. Reply Declaration of Haim Mendelson, ¶¶ 10-11 at 6-7. The average price improvement over these thirty-four transactions was $0.16 per share. Plaintiffs contend that this creates an inference "that it is more likely than not that a better price was available on Instinet between the times Merrill Lynch re-

ceived and executed Mr. Zakheim's order." Id., ¶ 12 at 7. Based on the average price improvement demonstrated in the thirty-four transactions, Zakheim's damage was $19.20 on the 120-share transaction.

With respect to this June 7, 1994 transaction, plaintiffs allege an additional theory of damage. No in-house market orders were available for crossing with Zakheim's market order at or about the time this trade was executed. Reply Declaration of Haim Mendelson, ¶ 14 at 7. Plaintiffs contend, however, that market orders of other Merrill Lynch customers could have been crossed with each other at the start of trading on the same day. For example, two unexecuted market orders to buy 450 shares in total and two unexecuted market orders to sell 305 shares in total were held by Merrill Lynch as of 9:27:35 on June 7, 1994. Plaintiffs contend that 305 shares could have been exchanged at a price midway between the respective offers at that time without Merrill Lynch's participation in the current spread. *Id.*, ¶¶ 15-16 at 8. At the time, the NBBO bid price was 41½ and the NBBO ask price was 41¾, yielding a spread of ¼. Zakheim's loss under this theory is based on one-half of the spread which Merrill would have gained by selling to Zakheim at the NBBO asking price rather than crossing his order with another in-house market order, had one been available, at a price midway between NBBO bid and ask. The resultant damage calculation is $15 on the 120-share transaction. This damage theory fails to recognize that widely accepted principle, noted by plaintiffs themselves, Plaintiff's Memorandum In Opposition at 43, n.32, that class representatives cannot rely upon injury to absent class members but must allege personal injury. *Warth v. Seldin,* 422 U.S. 490, 493 (1975); *Cent'l Wesleyan College v. W.R. Grace & Co.*, 6 F.3d 177, 188 (4th Cir. 1993); *Casey v. Lewis,* 4 F.3d 1516, 1519 (9th Cir. 1993); *Griffin v. Dugger,* 823 F.2d 1476, 1482 (11th Cir. 1987), *cert. denied,* 486

U.S. 1005 (1988); *Brown v. Sibley*, 650 F.2d 760, 771 (5th Cir. 1981).

No information on either Instinet prices [8], SOES limit order file prices or payment for order flow arrangements was supplied for any of the transactions.

Data on contemporaneous Selectnet prices were supplied in six other transactions [9] but no available superior price was shown in any of them. For example, on Sept. 21, 1994, the day of plaintiff Kravitz's 100 share purchase of Safety Components executed by Dean Witter as agent at a price of 19, three SelectNet offers for Safety Components were posted:

1) At 10:18:28 an offer to sell any quantity of 600 shares or less at a price of 18¾, good for three minutes,

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[8] Merrill Lynch provided a "TMTR Trade Report" showing "the time and place of transactions by all market makers in U.S. Healthcare at or around the time of [plaintiff Zakheim's June 7, 1994] transaction." Declaration of Hugh Quigley, ¶ 5. Although some of those transactions took place on Instinet, "[b]ecause of the NASD reporting rules, a large number of transactions executed through Instinet will not [be labelled as such in] the TMTR Trade Report and hence will not be identifiable as Instinet transactions." Reply Declaration of Haim Mendelson, ¶ 8(b) at 5. Thus although some Instinet information is provided in this TMTR Trade Report, it is incomplete no inference on contemporaneous Instinet activity can be drawn.

[9] July 18, 1994 (Binder sale of 1000 shares of Optical Radiation through PaineWebber as agent);

Oct. 20, 1993 (Kravitz purchase of 100 shares of Iwerks Entertainment through Dean Witter as agent);

Sept. 21, 1994 (Kravitz purchase of 100 shares of Safety Components through Dean Witter as agent);

Feb. 11, 1994 (Kravitz purchase of 100 shares of Simpson Industries through Dean Witter as agent);

Feb. 1, 1994 (Kravitz purchase of 100 shares of Envoy CP with Dean Witter as principal); and

Dec. 29, 1993 (Kravitz sale of 100 shares to Spectrum Information Technologies to Dean Witter as principal).

was broadcast to all market makers. The offer was accepted (for all 600 shares at the offered price) at 10:19:21.

2) At 11:07:11 an offer to sell any quantity of 600 shares or less at a price of 18½, good for three minutes, was broadcast to all market makers. The offer was accepted (for all 600 shares at the offered price) at 11:07:25.

3) At 15:39:41 an offer to purchase exactly 1000 shares at a price of 17¾, good for three minutes, was broadcast to all market makers. The offer was withdrawn nineteen seconds later at 15:40:00 without being accepted.

At the time the Kravitz's order was executed by Dean Witter on the SOES system, 13:10, none of the day's three SelectNet orders were open and available. Therefore, with respect to SelectNet, plaintiff Kravitz suffered no damage in this transaction. It is conceivable, but not established, that Instinet or the SOES limit order would show better prices in the transactions for which SelectNet data was supplied as well as in the remaining three transactions [10] for which no information on any alternative sources of liquidity was provided.

According to plaintiffs, "[T]hroughout the Class Period [November 4, 1992 to November 4, 1994], each Defendant *daily* took *tens of thousands* of relatively small orders from their respective retail customers, including Plaintiffs and members of the Class, to buy and sell *tens of millions* of shares of stock." Amended Complaint ¶ 25 (emphasis added). The foregoing examples of just a few of plaintiffs'

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[10] Nov. 10, 1993 (Kravitz purchase of 100 shares of Cellular through Dean Witter as agent);

Nov. 10, 1993 (Kravitz sale of 262 shares of IDB Communications through Dean Witter as agent); and

Aug. 25, 1993 (Kravitz purchase of 100 shares of Scientific Games through Dean Witter as agent).

transactions suggest i) that determining damages under plaintiffs' theory would be no easy task and, ii) more important, the additional inquiries which would have to be made when executing each defendant's tens of thousands of daily relatively small orders might be so time consuming and burdensome that customers would be prejudiced through the inability of broker/dealers to execute customer orders in a timely and inexpensive manner. These considerations must be among those which are causing the regulatory agencies to move with care when devising new rules on this subject. These considerations must also be a reason why the proposed new rules appear to be moving in the direction of modifying the computation of the NBBO rather than imposing additional duties of inquiry upon broker/dealers.

Giving the non-moving party the benefit of the doubt, as is required under summary judgment standards, I will assume, arguendo, that the missing data would reveal some damage in a sufficient number of the transactions to surmount the standing challenge. Such "damages," of course, assume the validity of plaintiffs' substantive claims.

E.—DISCUSSION

Standard For Summary Judgment

A court must grant summary judgment if the moving party establishes that "there is no genuine issue as to any material fact and that . . . [it] is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). Once the moving party has carried its burden under Rule 56(c), "its opponent must do more than simply show that there is some metaphysical doubt as to the material facts in question." *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 586 (1986), *rev'g* 723 F.2d 238 (3d Cir. 1983). The opposing party must set forth specific facts showing a genuine issue for trial, and may not rest upon the mere allegations or denials of its pleadings.

See Celotex Corp. v. Catrett, 477 U.S. 317, 324 (1986); *First National Bank v. Cities Service Co.*, 391 U.S. 253, 289, *reh'g denied*, 393 U.S. 901 (1968); *Sound Ship Bldg. Corp. v. Bethlehem Steel Co.*, 533 F.2d 96, 99 (3d Cir.), *cert. denied*, 429 U.S. 860 (1976). In applying Rule 56(c), the Supreme Court has held that:

> By it very terms, this standard provides that the mere existence of *some* alleged factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment; the requirement is that there be no *genuine* issue of *material* fact.

Anderson v. Liberty Lobby, Inc., 477 U.S. 242, at 247-48 (1986).

A genuine issue for trial is present whenever "the evidence presents a sufficient disagreement to require submission to a jury." *id.* at 251-252. In contrast, whenever "the record taken as a whole could not lead a rational trier of fact to find for the non-moving party, there is no 'genuine issue for trial.'" *Matsushita*, 474 U.S. at 587. In evaluating the record, the court must both weigh the evidence and draw inferences from it "in the light most favorable to the party opposing the motion." *Whitehead v. St. Joe Lead Co., Inc.*, 729 F.2d 238, 251 (3d Cir. 1984) (quoting *Coastal States Gas Corp. v. Department of Energy*, 644 F.2d 969, 979 (3d Cir. 1981)); *Wahl v. Rexnord, Inc.*, 624 F.2d 1169, 1181 (3d Cir. 1980).

A material fact for each party is one which assists in "establish[ing] the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial." *Celotex Corp.*, 477 U.S. at 321. Although it has been advised that "summary judgment should be used sparingly in complex . . . securities litigation where motive and intent play lead roles and the proof is largely in the hands of the defendants," *Allen Organ Co. v. North American Rockwell Corp.*, 363 F.Supp.

1117, 1124 (E.D. Pa. 1973), if a party fails to establish an essential element upon which it will bear the burden at trial "there can be 'no genuine issue as to any material fact,' since a complete failure of proof concerning an essential element of the non-moving party's case necessarily renders all other facts immaterial." *Celotex Corp.*, 477 U.S. at 321.

Fraud under Section 10(b) and Rule 10b-5

In fulfillment of the Congressional purpose "to substitute a philosophy of full disclosure for the philosophy of caveat emptor . . ." *SEC v. Capital Gains*, 375 U.S. 180, 186 (1963), and pursuant to the authority granted it in Section 10 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(a), the Securities and Exchange Commission has defined fraudulent use of "manipulative and deceptive devices" in the context of the securities industry:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

The parallel to common law fraud is not coincidental: "The federal securities statutes were modeled after the common law actions of fraud and deceit." *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1049 (11th Cir. 1987). In order to prevail on a section 10b-5 claim, a plaintiff must show that:

> 1 a security was sold or purchased accompanied by a misrepresentation or omission of a material fact
>
> 2 defendant acted with scienter
>
> 3 the plaintiff justifiably relied on such misrepresentation in connection with the purchase or sale of a security; and
>
> 4 the plaintiff suffered damage as a result of the misrepresentation or omission.

Sowell v. Butcher & Singer, Inc., 926 F.2d 289, 296 (3rd Cir. 1991). Failure to disclose a material fact is a misrepresentation. *Chiarella v. United States*, 445 U.S. 222, 229 (1979); *Rochez Bros., Inc. v. Rhoades.*, 491 F.2d 402, 407-8 (3d Cir. 1974). Where a reasonable man would attach importance to facts in determining his choice of action in the transaction in question, the facts are material. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.) *cert. denied* 382 U.S. 811 (1965). Scienter is a necessary element in actions brought under Section 10 and Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) ("The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct."). Conduct that is an "extreme departure from the standards of ordinary care," *Shivangi v. Dean Witter Reynolds, Inc.*, 825 F.2d 885, 889 (5th Cir. 1987), may be sufficiently reckless to also form scienter. *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977); *McLean v. Alexander*, 599 F.2d 1190, 1197 n.12 (3d Cir. 1979).

Misrepresentation

A broker/dealer owes a fiduciary duty to a retail customer. "[T]he duties of a securities broker are, if anything, more stringent than those imposed by general agency law. All that is necessary [to show fraud based on those duties] is to hold defendant to standards that would govern an agent for the sale of potatoes." *Opper*, 250 F.Supp. at 676; *In re Kidder, Peabody & Co., Inc.*, 43 S.E.C. 911, 915 (1968).

The fiduciary duty is fundamental to the broker/client relationship:

> [W]hen one is engaged as agent to act on behalf of another, the law requires him to do just that. He must not bring his own interests into conflict with his client's. If he does, he must explain in detail what his own self-interest in the transaction is in order to give his client an opportunity to make up his own mind whether to employ an agent who is riding two horses.

L.Loss, *The SEC and the Broker-Dealer*, 1 Vand. L. Rev. 516, 522 (1948). Although it might grow out of broker/dealers' role as agent, the duty does not disappear when the role of principal is assumed. "A broker-dealer's determination to execute an order as principal or agent cannot be 'a means by which the broker may elect whether or not the law will impose fiduciary standards upon him in the actual circumstances of any given relationship or transaction.'" *E.F. Hutton & Co.*, Securities Exchange Act Release No. 25887, Fed. Sec. L. Rep. (CCH) ¶ 84,303, 89,326, 89,328 (July 6, 1988) (*quoting Opper*, 250 F. Supp. at 675).

> The fiduciary duty gives rise to a duty to disclose information in the sole possession of the agent in various circumstances.

> [A]dministrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure . . . [S]uch liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.

Chiarella, 445 U.S. at 230. "In circumstances where a broker-dealer's interests conflict with those of the customer . . . [the broker must] disclose all material information to enable the customer to make an informed decision regarding whether to complete the transaction." *Market 2000*, Study V at *2.

No express representation is alleged to have been made to any of the plaintiffs in the present case, but defendants concede that "by holding themselves out as professionals, brokers make an implicit representation to the public that they [will] charge customers 'fair' prices. . ." Defendants' Memorandum In Support of Motion to Dismiss at 31. The crux of the dispute represented by this litigation is disagreement over the meaning of the term "fair" in this context. Plaintiffs allege that defendants' implied representation of fair dealing, upon which they relied, included an obligation, pursuant to the fiduciary nature of the relationship between them, to disclose the material fact that defendants intended to execute plaintiffs' orders at the NBBO rather than at superior available prices in order to satisfy their duty of best execution. Amended Complaint §§ 31-32. The use of various manipulative devices to secretly accrue profits for their own accounts, according to plaintiffs, amounted to a further breach of the duty to disclose and thus a further fraud. Amended Complaint §§ 33-38. Defendants, on the other hand, maintain that "fair" simply means execution at prices no worse than the

current NBBO and that such transaction is equivalent to best execution.

This requires a review of the duty of best execution. Neither party disputes that "fairness" includes a duty of best execution, but the term itself eludes definition: despite its central nature, it inhabits the texts of securities law without revealing its source. "[T]he Commission has not promulgated a separate best execution rule or explicitly defined best execution . . ." *Market 2000,* Study V at *5-6. While Congress, in establishing the NASDAQ, attempted to assure "the practicability of brokers executing investors' orders in the best market," 15 U.S.C. § 78k-1(a)(1)(C)(iv), the duty is ultimately founded in common law:

> A broker-dealer's duty to seek to obtain the best execution of customer orders derives from the common law agency of loyalty, which obligates an agent to act exclusively in the principal's best interest . . . [the agent] is under a duty to exercise reasonable care to obtain the most advantageous terms for the customer.

Market 2000, Study V at *2 *quoting* Restatement 2d of Agency §§ 387 and 424 (1958).

This common law has spawned various interpretative rules when applied to the various securities markets. *See, e.g.,* American Stock Exchange Rule 156(a), 2 Amex Guide (CCH) P 9296,. and New York Stock Exchange Rule 123A.41, 2 NYSE Guide (CCH) P 2123A (requiring members handling market orders to exercise diligence to execute orders at the best prices available). The corresponding NASD rule, cited by defendants, however, exemplifies the imprecision of these rules and the difficulty of using them to clarify the precise meaning of best execution with respect to exclusive use of the NBBO. The NASD rule reads:

> In any transaction for or with a customer, a member . . . shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and

> buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.

NASD Rules of Fair Practice, NASD Manual (CCH), Art. III, Sect. 1, ¶ 2151.03. Since a broker/dealer may transact in the same security with a market maker on any one of a number of execution systems, some of which yield different prices, guidance limited to a requirement to determine which market maker is giving the best price when market makers themselves are offering different prices on different systems, can hardly be called helpful.

To add to the difficulty, "best execution" does not necessarily mean "best price." Other factors, such as reliability and speed, have to be considered.

> [B]rokers have not been held . . . to an absolute requirement of achieving the most favorable price on each order[.] [W]hat has been required is that the broker endeavor, using due diligence, to obtain the best execution possible given all the facts and circumstances. These factors include, among other things, the size of the order, the trading characteristics of the security involved, the availability of accurate information affecting choices as to the most favorable market in which execution might be sought, the availability of technological aids to process such data, the availability of economic access to the various market centers and the costs and difficulty associated with achieving an execution in a particular market center.

Second Report on Bank Securities Activities: Comparative Regulatory Framework Regarding Brokerage-Type Services 97-98, n.233 (Feb. 3, 1977), *as reprinted in* H.R. Rep. No. 145, 95th Cong., 1st Sess. 2333. It may well be that in any given transaction inquiry of all relevant markets and pending orders might produce a price superior to the NBBO price, but it may not constitute best execution in that transaction because of delay and it may

not constitute best execution generally because were the practice followed in all transactions the interests of all customers in an inexpensive and efficient market might be impaired.

As noted above, none of the sources cited by the parties in support of their respective interpretations of the prevailing standard for the duty of best execution reveals a rule, regulation or interpretation of a regulation which directly addresses the question of whether exclusive reference to the NBBO satisfies that duty. Defendants' narrow interpretation of such terms as "interdealer market" and "best current displayed bid or offer" affords them the opportunity to infer support from sources that do not in fact limit broker/dealers' duty to an obligation to refer only to the interdealer market or quotation display represented by the NASDAQ system. Plaintiffs, on the other hand, offer only broad statements concerning the duty of broker/dealers to obtain best execution that make no mention of the NBBO.

Attempts to rely on industry custom to clarify the prevailing standard for duty of best execution during the class period are similarly of no avail. The affidavits supplied by the parties on market practices predictably contradict each other in conclusory terms that rely solely on the authority of their authors. Declarations of T. Grant Callery, David S. Ruder, Richard Y. Roberts and Junius W. Peake. On balance they provide little guidance. The affidavit of a former OTC trader who attested to his regular use of sources other than the NBBO also failed to shed any light on industry custom during the class period because it described only conduct that preceded the class period. Declaration of Paul M. Lacy, ¶ 2.

Thus it is an undisputed fact that highly qualified, totally responsible participants in the securities market have differing opinions about the best way to execute OTC orders. The regulatory agencies which are experts

in the field are seeking the best approach which will serve the immediate interests of customers and the long-term interests of customers and other market participants in an effective securities market.

Moreover, it is unclear that demonstrating industry custom would be determinative: SEC and judicial rulings concerning failure to exercise reasonable diligence to obtain best execution or to provide sufficient disclosure in the absence of obtaining best execution have been limited to cases in which there have been express representations contrary to existing regulations or SEC interpretations thereof. *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944) (broker-dealer's license revoked as a result of willful violations of Securities Act of 1934); *Opper* (broker made explicit representations that he was attempting to execute plaintiff's orders when in fact he was trading on his own behalf in the same security); *Barnett v. United States*, 319 F.2d 340 (8th Cir. 1963) (Violation of securities antifraud provisions found where firm, after expressly accepting customer's order to sell, traded on its own behalf in same security without executing customer's order).[11]

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[11] Plaintiffs cite *Chassins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970) for the proposition that even if it were industry custom to execute exclusively at the NBBO, defendants could not use such industry wide practice as a shield against an allegation of misrepresentation because "[E]ven where a defendant is successful in showing that it has followed a customary course in the industry, the first litigation of such a practice is a proper occasion for its outlawry if it is in fact in violation." Two factors differentiate this case from the present one: 1) The court in *Chassins* was clear to limit its decision to "the particular circumstances proved in this case." *Chassins*, 438 F.2d at 1172. "We do not attempt to address ourselves to the question of [the relevant industry policy]." *Id.* 2) The circumstances surrounding the parties' interaction in *Chassins* were established in great detail and the omission, a failure to inform the customer of the broker/dealer's market maker status, was placed in this context of express representations. Plaintiffs'

Plaintiffs here have made no allegations that any express representation was made in any of the subject transactions. No special circumstances are shown. Rule 10b-5 makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, *in the light of the circumstances under which they were made,* not misleading." 17 C.F.R. § 240.10b-5(b) (emphasis added). "[W]hat has been required is that the broker endeavor, using due diligence, to obtain the best execution possible *given all the facts and circumstances.*" *Payment For Order Flow,* Exchange Act Release No. 33206 [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,234, 84,536 at 84,541 (emphasis added). Even if plaintiffs, as class representatives, were to show some special circumstances, pursuit of the class action would be prohibitively unwieldy, requiring investigation into each and every covered transaction to determine what special circumstances, if any, were sufficiently similar to those alleged in the complaint to warrant inclusion in the class.

Furthermore, the implied representations, a promise of "fair dealing," specifically, to obtain best execution, are built on shifting sands: no one is sure quite what best execution means in all circumstances. It may be that best execution was not in fact satisfied in th subject transactions by exclusive reference to the NBBO, but it would be highly imprudent to hold defendants liable for making a material omission of fact by means of an implied representation based on a ill-defined duty that the relevant regulatory agency is only now struggling to clarify for an industry that is constantly undergoing technological change.

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allegations here are premised on solely on the general nature of the relationship between the parties and make no effort to particularize any misrepresentations.

Scienter

Even if defendants, in holding themselves out as broker/dealers who would charge their customers "fair" prices, made an implied representation that "omitted" a material fact, that is, that there might be prices better than the NBBO available, a jury could not reasonably find that there was an intent to deceive or an "extreme departure from the standards of ordinary care" sufficient to constitute the requisite scienter for a claim of fraud. Knowledge of omitted facts on its own does not establish scienter. *SEC v. Southwest Coal & Energy Co.*, 624 F.2d 1312, 1321 n.17 (5th 1980) ("[K]nowledge of the fraud, and not merely the undisclosed facts, is indispensable . . ." to proving securities fraud. *Quoting Hirsh v. duPont*, 553 F.2d 750, 759 (2d Cir. 1977)). There must be an intent to deceive, *Ernst*, 425 U.S. at 197 and 199; *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J.) "[I]mposition of liability for damages under Rule 10b-5(2), absent a *scienter* requirement . . . would [] go beyond the authority vested in the Commission by § 10(b) to act against 'any manipulative or deceptive device or contrivance' and be so inconsistent with the general structure of the statutes as to be impermissible . . ."); or a reckless omission of material facts, *Coleco Industries, Inc. v. Berman*, 567 F.2d 569 (3d Cir. 1977) (per curiam), *cert. denied*, 439 U.S. 830 (1978) (scienter element in a § 10(b) case requires "a conscious deception or . . . a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception."); *McLean* at 1197 n.12; *see also Sundstrand Corp.*, 553 F.2d at 1044-45; *Shivangi*, 825 F.2d at 889; *and Franke v. Midwestern Oklahoma Development Authority*, 428 F.Supp. 719, 725 (W.D. Okl. 1976) ("[R]eckless conduct may be defined as a highly unreasonable omission, involving . . . an extreme departure from the standards of ordinary care . . .").

It is undisputed that defendants' reliance on NBBO prices when executing small orders is widely, if not almost universally followed with respect to OTC securities. That this is the practice is fully known in the industry. It is no secret. The issue before the regulatory agencies is whether the practice should be modified and, if so, how.

The absence of contemporaneous SEC or NASD guidance on the validity of exclusive reference to the NBBO makes formation of an intent to deceive as to the sufficiency of such conduct a contradiction of terms. Broker/dealers are obliged by statute to adhere to SEC and NASD regulations. Where there is no regulation in place, it might reasonably be argued that there could be commission of an act which later, after promulgation of relevant rules, could be said to have been unfair, but it cannot be maintained that an intent to deceive as to a prevailing standard could exist when the standard was, at the time, as yet undetermined by the relevant authorities. *Christidis v. First Pennsylvania Mortg. Trust*, 717 F.2d 96, 100 (3d Cir. 1983) (dismissal for lack of scienter in securities fraud action brought under Section 10(b) was based on Rule 9(b) defect of failure to show that "defendants knowingly departed from reasonable [industry] practices."). The alternative contention that there might be liability for reckless departure from an ordinary standard of care when the current standard of care was at best ambiguous is similarly untenable: one cannot recklessly disregard that which is not discernible. *See Platsis v. E.F. Hutton & Co.*, 946 F.2d 38, 41 ("Since very few brokers disclosed [the alleged material fact] at the time the[] events took place and there was no established regulatory duty to disclose these items, an intent to deceive or an 'extreme departure from the standards of ordinary care' could not be established merely by the omission of this information in the absence of special circumstances.")

Scope of Judicial Scrutiny

In a modern market that involves both rapid evolution of technology and large-scale expansion of the use of that technology, a state of constant and sometimes radical change may, in one sense, represent the "status quo." For the past twenty years the world of the stock exchange floor, the ticker tape and face-to-face trading, while still an active part of the securities business, has steadily been giving way to the world of quotation display screens and on-line transactions. Much of the trading that only recently took place on a handful of national exchanges now occurs on large, decentralized networks of electronically linked offices throughout the world. The constant challenge presented by technological improvements, new investment vehicles and the rise of new trading methods in this evolving environment makes the need for a governmental agency dedicated exclusively to monitoring and regulating its smooth functioning all the more evident.

Congress has established the manner in which rules governing the OTC market should be devised. NASDAQ is an indirect subsidiary of the NASD. The NASD is a self-regulatory organization that is empowered by statute to operate the NASDAQ system and to promulgate and enforce rules of conduct for all firms that act as securities brokers or dealers. Under the Securities Exchange Act of 1934, all brokers and dealers must be NASD members, and are subject to the rules and standards imposed by the NASD. 15 U.S.C. § 78o(b)(8). The SEC must review and approve any NASD rule before the rule becomes effective. 15 U.S.C. § 78s. The NASD and SEC are the agencies to which Congress has assigned these comprehensive and delicate tasks, which require a depth of expertise and familiarity with the markets.

"The SEC [was] invested [by Congress] with broad discretionary powers equal to the complex and changing nature of the problems arising in the securities industry."

Gordon v. New York Stock Exchange, Inc., 498 F.2d 1303, 1306 (2d Cir. 1974), aff'd 422 US 659 (1975) (cf. H.R. Rep. No. 1383 at 6-7, 73d Cong, 2d Sess (1934)). It is inappropriate for courts to interfere with that mandate except under extraordinary circumstances. "[T]he expertise of [the agency] is far greater than that possessed by the courts . . . at least with respect to the economic complexities and technicalities inherent in [the regulated industry]." *Movers' & Warehousemen's Ass'n. of Amer. v. United States*, 303 F.Supp. 563 (D.N.J. 1969). The Supreme Court has said "[The function of an agency] is not only to appraise the facts and to draw inferences from them but also to bring to bear upon the problem an expert judgment and to determine from its analysis of the total situation on which side of the controversy the public interest lies." *United States et al. v. Detroit & Cleveland Navigation Co. et al.*, 326 U.S. 236, 241 (1945).

The issues which plaintiffs raise have been and are being specifically addressed by the SEC and the NASD. The rules recently proposed by the SEC contemplate the inclusion of any quotes posted on any alternative sources in the required best bid/ask quotation that broker/dealers are required to post on NASDAQ Levels 2 and 3.

> The proposed amendments . . . are intended to improve the quality and expand the scope of published quotation information from OTC market makers and specialists by requiring them to reflect in their public quotes the bid and offer prices (*e.g.*, priced orders) they disseminate through electronic communications networks that provide the ability to execute against these priced orders.

Order Execution Obligations at 21-22. Thus the NBBO, the composite best bid and offer as derived from all market makers posted quotes, would, if the proposals are adopted, reflect not just the best prices available on the NASDAQ

Level 2, but the best prices available from *all* sources, including SelectNet and Instinet. In choosing to remedy the problem of the "splintering" of quotaton information, whereby "OTC market makers and specialists publish[] different proposed trading prices in different quotation systems, some with limited access," *id.* at 20, by "expanding" the NBBO rather than clarifying the nature of the broker/dealers' obligation to maintain parity with the NBBO, the SEC has considered all the relevant commercial, technical, and legal factors, applied its expertise and devised a regulatory scheme that best protects the public interest. NAqcess, the proposed replacement for the SOES system that would allow interaction between retail limit orders and market orders is a similarly carefully considered solution, designed to accommodate the various and sometimes conflicting interests of professional traders, their customers and the general public.

It should be noted that the solutions proposed by the regulatory agencies eliminate difficulties that would be inherent in the procedures which plaintiffs contend defendants should have followed. Broker/dealers could in the usual situation still refer to a single quotation system, the NBBO, modified to reflect additional data. They would not have to delay execution of orders by referring to multiple quotation systems, some of which might be available to all broker/dealers. It should also be noted that the proposed regulations are prospective only.

Thus, without commenting on the sufficiency of exclusive reference to the NBBO to satisfy the duty of best execution, the SEC has, in its wisdom, determined that it is in the interest of maintaining fair and orderly markets and assuring "the practicability of brokers executing investors' orders in the best market," 15 U.S.C. § 78k-1(a)(1)(C)(iv), that the NBBO should reflect the full range of interdealer quotes and that some retail limit and market orders should be crossed. Such a pronouncement indicates

that the appropriate regulatory agency, in its capacity as the governmental body charged with maintaining expertise on the current condition of the securities markets and overseeing their fair and efficient operation, has studied the problem of ensuring best execution of retail customers' orders, has taken into consideration the state of the technology and the proliferation of alternative sources of liquidity, has weighed the competing interests of cost of compliance and public confidence and has fashioned a solution that takes into account all the relevant factors.

These regulatory developments confirm that defendants cannot have misrepresented material facts by following existing practices and that defendants cannot have acted with scienter when only now the regulatory agencies are exploring and adopting regulations designed to meet a continually evolving market.

It would not be appropriate for a court or a jury to inject itself into this carefully considered determination. The court has not been asked to prospectively enjoin the defendants, to review administrative regulations for arbitrary and capricious use of regulatory discretion or to compel the SEC to fulfill its statutory mandate. Plaintiffs are effectively asking the court to retroactively second-guess the SEC. While the comprehensive scheme devised by Congress to regulate the securities industry may itself be ripe for reform [12], the judiciary should not be used as a method to bypass that scheme. In light of all the fore-

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[12] In response to criticism that the NASD has failed to keep pace with the growth and evolution of the NASDAQ market, the NASD recently accepted the recommendation of an advisory committee, chaired by former Senator Warren B. Rudman, to implement a major structural reorganization, breaking the NASD into three independent bodies, in charge of policymaking, regulation of broker/dealers and operation of NASDAQ respectively with each entity governed by mixed boards of industry and non-industry representatives. *Executive Summary of the Report of the NASD Select Committee on Structure and Governance to the NASD Board of Governors* at 21-22.

going, summary judgment must be granted in favor of defendants on plaintiffs' federal claims.

State Law Claims

Count II of the Amended Complaint alleges breach of fiduciary duty under state law. Count III alleges unjust enrichment under state law. Insufficiency of a claim under federal securities laws does not necessarily preclude liability under state common law, *Santa Fe Industries, Inc. v. Green,* 430 U.S. 462, 479 (1977); *Gochnauer,* 810 F.2d at 1050. However, district courts may decline to exercise supplemental jurisdiction over a pendant state claim "if the district court has dismissed all claims over which it has original jurisdiction." 28 U.S.C. § 1367(c)(3); *United Mine Workers v. Gibbs,* 383 U.S. 715, 726 (1966) ("If the federal claims are dismissed before trial, even though not insubstantial in a jurisdictional sense, the state claims should be dismissed as well"); *Tully v. Mott Supermarkets, Inc.,* 540 F.2d 187, 196 (3d Cir. 1976) (Dismissal of pendant state law claims in a securities fraud action brought under Section 10(b): "If it appears that the federal claim is subject to dismissal . . . or could be disposed of on a motion for summary judgment under F.R.Civ.P. 56, then the court should ordinarily refrain from exercising jurisdiction . . ."). Accordingly, plaintiffs' state law claims will be dismissed without prejudice.

CONCLUSION

For the reasons stated above, the motion of defendants for summary judgment on plaintiffs' federal claims is granted. Plaintiffs' state law claims will be dismissed without prejudice.

An appropriate order follows.

/s/ Dickinson R. Debevoise
DICKINSON R. DEBEVOISE
U.S.S.D.J.

Date: December 13, 1995.

[Filed Dec. 15, 1995]

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civ. No. 94-5343 (DRD)

IN RE MERRILL LYNCH, *et al.*
SECURITIES LITIGATION

ORDER

These matters having been opened to the Court by defendants PaineWebber, Inc., Merrill Lynch Pierce Fenner & Smith, Inc., and Dean Witter Reynolds, Inc., and notice having been given to all parties, in consideration of the papers submitted, for good cause shown, and for the reasons set forth in the Court's opinion of even date,

IT IS, on this 13th day of December, 1995,

ORDERED as follows:

1. Defendants' motion for summary judgment on plaintiffs' federal claims is granted.

2. Count I of the Amended and Consolidated Class Action Complaint is dismissed with prejudice.

3. Counts II and III of the Amended and Consolidated Class Action Complaint are dismissed without prejudice.

/s/ Dickinson R. Debevoise
DICKINSON R. DEBEVOISE
U.S.S.D.J.

APPENDIX D

Opinion and Order of the United States District Court for the District of New Jersey, *In re Merrill Lynch, et al. Securities Litigation*, No. 94-5343 (DRD) (Sept. 14, 1995)

[Filed Sep. 14, 1995]

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civ. No. 94-5343 (DRD)

IN RE MERRILL LYNCH, *et al.*,
SECURITIES LITIGATION

OPINION

Debevoise, Senior District Judge.

Defendants move to dismiss plaintiffs' amended complaint. For the reasons which follow, the motion to dismiss will be converted into a motion for summary judgment.

BACKGROUND

This is a class action against securities dealers Painewebber, Inc. ("Painewebber"), Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"), and Dean Witter Reynolds, Inc. ("Dean Witter"). The plaintiffs claim that those defendants committed unlawful and fraudulent acts against them in violation of Section 10(b) of the Federal Securities Exchange Act of 1934 ("Section 10(b)"), Rule 10b-5 promulgated thereunder ("Rule 10b-5"), and applicable state common law. This alleged violation occurred when the defendants purportedly acted to benefit themselves at the expense and to the detriment of plaintiffs and the class by fraudulently and/or recklessly fail-

ing to fulfill their duty to execute market orders at the best reasonably available prices.

The plaintiffs are customers of the defendants. Plaintiff MLPF&S Cust. FPO, Bruce Zakheim IRA FBO Bruce Zakheim, is a New Jersey resident. During the Class Period, Zakheim was a retail customer of Defendant Merrill Lynch and placed market orders for over-the-counter ("OTC") stocks through a Merrill Lynch retail stock broker at a Merrill Lynch office located in Marlton, New Jersey. For example, on June 7, 1994, a market order was placed with Merrill Lynch to buy 120 shares of U.S. Healthcare stock. Merrill Lynch allegedly did not execute that order at the best available price, thereby damaging Zakheim.

Plaintiff Jeffrey Phillip Kravitz is a California resident. During the Class Period, Kravitz was a retail customer of defendant Dean Witter and place market orders for OTC stocks through a Dean Witter retail stock broker at a Dean Witter office in Malibu, California. For example, on February 11, 1994, a market order was placed with Dean Witter to buy 100 shares of Simpson Industries stock and on September 21, 1994, a market order was placed with Dean Witter to buy 100 shares of Safety Components stock. Dean Witter allegedly did not execute either one of these orders at the best available stock price, thereby damaging Kravitz on both transactions.

Plaintiff Gloria Binder is a New York resident. During the Class Period Binder was a retail customer of defendant Painewebber and placed market orders for OTC stocks through a Painewebber retail stock broker at a Painewebber office in Melville, New York. For example, on April 21, 1994, a market order was place with Painewebber to buy 1,000 shares of Optical Radiation stock. Painewebber allegedly did not execute the order at the best available price, thereby damaging Binder.

The defendants in this case are members of the National Association of Securities Dealers ("NASD"), a trade asso-

ciation of securities brokers and dealers. Under the Securities Exchange Act of 1934, all brokers and dealers must be NASD members, and are subject to the rules and standards imposed by the NASD. The Securities and Exchange Commission ("SEC") must review and approve any NASD rule before the rule becomes effective.

The NASD has set up an automated quotation system called NASDAQ, which is the fastest growing stock market in the United States. NASDAQ stocks are traded over-the-counter, by way of computer and telephone communication between separated independent securities dealers. As an interdealer market, NASDAQ relies on competition among approximately 500 market-making firms. Unlike auction markets such as the New York Stock Exchange, NASDAQ does not depend on centralizing order flow in one location where "matching" orders from public customers will be executed against each other. NASDAQ relies on competition among many dealers risking their own capital, rather than a single regulated monopolist or stock exchange "specialist" firm, to assure liquidity.

Upon receiving an order to buy stock, defendants will buy securities at a "bid" price and sell them to customers at a higher "ask" or "offer" price, making a "two-sided" market. Market makers therefore make a part of their compensation from the "spread" between the bid and the ask price.

All market makers have access to NASDAQ workstations that include a "Level 2" screen showing the bid and ask prices of other market makers. For any given NASDAQ stock, the highest bid price and the lowest ask or offer price among all dealers making a market in the stock is sometimes referred to as the "NBBO"—the national best bid and offer. A broker buying stock at the NBBO is buying stock for a customer at the best price quoted by any market maker on the NASDAQ system.

The stock transactions which plaintiffs allege were in violation of federal securities laws and state common law

were executed at the NBBO. It is plaintiffs' contention that the lowest price—and therefore the best price—was not at the NBBO. Rather, plaintiffs assert that the defendants could have offered them a lower price based on alternative price quotation systems to which defendants have access. Those systems, which defendants use to execute trades on their own accounts, provide execution prices from other broker-dealers and institutional customers. The systems include SelectNet and Instinet.

SelectNet is a communications feature that is currently available to all NASDAQ market makers through their computer workstations. It is essentially a substitute for telephone communication. Therefore, it is not a continuous two-sided market, but rather a proposal from one dealer to another to engage in a specific transaction in a specific security at a specific price.

Instinet is private corporation owned and operated by Reuters Holdings PLC. It is a stock brokerage service by which institutions can electronically display prospective transactions by way of computer hook-ups to firms that pay a subscription fee to Instinet.

In the Amended Complaint, the plaintiffs allege that defendants did not execute the plaintiffs' stock orders at the best available prices, that the plaintiffs' were caused injuries by not receiving the best available prices, and that the defendants profited from the failure to sell or buy at the best available price through one or more of six deceitful and fraudulent devices, without knowledge or consent of the plaintiffs. The defendants allegedly used the following devices to generate undisclosed profits for themselves at the expense and to the detriment of the plaintiffs:

* acquiring stock for their own inventories from retail customers (who placed market orders to sell stock) at prices lower than otherwise available market prices, and selling stock out of inventory to

retail customers (who placed market orders to buy stock) at higher than otherwise available market prices;

* receiving and executing market orders to sell and to buy equal amounts of shares in the same stock at the NBBO quotes, thus appropriating the difference between the NBBO quotes to themselves while incurring no risk, instead of crossing the orders and executing both sides between the spread;

* executing orders for shares of particular stocks at the NBBO quotes even where superior prices were available through, for example, Instinet and Select-Net, that would result in better execution prices and result in a smaller overall spread (reflecting less risk) between the lowest market price available to a seller of such stock and the highest market price available to a buyer of such stock;

* executing orders to either sell or buy shares of particular stocks at the NBBO despite having received corresponding "limit" orders (orders to buy or sell a particular stock at a specific price or better) from other customers to sell or buy shares of that same stock at prices superior to the NBBO;

* executing market orders to either sell or buy shares of particular stocks at the NBBO quotes despite better prices being available, and then immediately retrading those same shares at those better prices for defendants' own profits; and

* selling orders to other firms to execute at NBBO quotes, without knowledge or consent of the customers placing the orders, and without regard to the availability of superior execution prices.

DISCUSSION

Defendants move to dismiss the Amended Complaint for failure to state a claim. Defendants make two basic arguments in response to plaintiffs' allegations. First, they assert that their best execution obligation is fulfilled when they execute a trade on behalf of their customers at the NBBO. Second, they contend that there is nothing wrong with the practice of market makers trading on their own accounts at prices that are "superior" to the retail prices available to plaintiffs and other retail investors. Defendants argue that both the SEC and the NASD have approved of both of the above practices.

Plaintiffs dispute defendants' contention that selling OTC stocks to their customers at the NBBO fulfills their best execution obligation. They contend that defendants' use of only the NBBO too narrowly defines the market from which they ascertain the best price for OTC stock. Plaintiffs insist that defendants have a duty to monitor the price they charge their other customers, which include institutional clients and other dealers, to ensure that public retail customers are receiving the best available prices. Plaintiffs additionally dispute the defendants' assertion that the SEC and the NASD have both decided that the use of the NBBO quote fulfills a dealer's duty of best execution.

Although the parties have done a fine job of briefing the issues involved in this case, additional information is necessary to decide whether the plaintiffs' claims have merit. Because there is not enough before the court to resolve the motion to dismiss on the pleadings, the motion will be converted into one for summary judgment.

Certain minimal factual data will be required in order to proceed with the pending motion. Each defendant is requested to supply by way of affidavit and supporting documents information relating to each transaction which

the defendants conducted on behalf of each named plaintiff, including the date of each order, the manner in which it was executed, the NBBO price and the prices of the security involved shown on the SelectNet and Instinet systems. In addition, each party is requested to submit by way of affidavit and pertinent documents information about market practices and regulatory requirements or advisories concerning transactions such as those which are the subject of the complaint.

The parties shall submit these factual materials on or before October 13, 1995. Any party may submit responsive material and shall submit supplemental briefs on or before October 27. The motion for summary judgment will be argued at 9 a.m. on November 13, 1995.

CONCLUSION

For the reasons set forth above, the motion to dismiss is converted into one for summary judgment, and the parties shall appear before this court on November 13 to argue the motion. An appropriate order follows.

/s/ Dickinson R. Debevoise
DICKINSON R. DEBEVOISE
U.S.S.D.J.

Date: September 13, 1995

[Filed Sep. 14, 1995]

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civ. No. 94-5343 (DRD)

IN RE MERRILL LYNCH, *et al.*,
SECURITIES LITIGATION

ORDER

This matter having been opened to the court upon motion of defendants' counsel; and the court having considered all papers submitted; and in accordance with the opinion of even date;

IT IS on this 13th day of September 1995

ORDERED as follows:

1. The motion to dismissed shall be converted to one for summary judgment;

2. The parties shall by October 13 submit affidavits and other information specified in the foregoing opinion;

3. The parties may by October 27 submit reply affidavits and documentation and shall submit supplemental briefs; and

4. Argument of the motion for summary judgment shall be held at 9:00 a.m. on November 13, 1995.

/s/ Dickinson R. Debevoise
DICKINSON R. DEBEVOISE
U.S.S.D.J.

APPENDIX E

Order of the Court of Appeals, *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 96-5045 (July 30, 1997)

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 96-5045

KENNETH E. NEWTON; MLPF&S CUST. BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM

v.

MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC.; PAINEWEBBER INC.; DEAN WITTER REYNOLDS
(D.C. No. 94-cv-05343)

JEFFREY PHILLIP KRAVITZ

v.

DEAN WITTER REYNOLDS, INC.
(D.C. No. 95-cv-00213)

MLPF&S CUST. FPO—BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM, JEFFREY PHILLIP KRAVITZ, and GLORIA BINDER,

Appellants

Present: SLOVITER, *Chief Judge*, BECKER, STAPLETON, MANSMANN, GREENBERG, SCIRICA, NYGAARD, ALITO, ROTH, LEWIS, *Circuit Judges*, and MAZZONE, *District Judge* *

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* Hon. A. David Mazzone, United States District Court for the District of Massachusetts, sitting by designation, as to panel rehearing only.

ORDER

A majority of the judges of this court in regular active service who are not disqualified having voted for rehearing en banc in the above appeal, it is

ORDERED that the Clerk of this Court vacate the opinion filed June 19, 1997 and list the above case for rehearing en banc at the convenience of the court.

By the Court,
/s/ Dolores K. Sloviter
Chief Judge

Dated: July 30, 1997

APPENDIX F

Securities Exchange Act of 1934, § 10(b),
15 U.S.C. § 78j(b)

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§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

APPENDIX G

17 C.F.R. § 240.10b-5

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.